81-2168

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No. _____

IN THE

Supreme Court of the United States

October Term, 1981

GEORGE A. CHESTNUTT, JR., WARREN K. GREENE, STANLEY L. SABEL, AMERICAN INVESTORS CORPORATION, and CHESTNUTT CORPORATION

Petitioners,

v.

ROSALIND FOGEL AND GERALD FOGEL,

Respondents.

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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United States Court of Appeals
SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse, in the City of New York, on the 22nd day of February, one thousand nine hundred and eighty-two.

ROSALIND FOGEL AND GERALD FOGEL,

Plaintiffs-Appellees,

-v-

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, WARREN K. GREENE, STANLEY L. SABEL, AMERICAN INVESTORS CORPORATION, and CHESTNUTT CORPORATION,

Defendants-Appellants,

and

FRANK G. FOWLER, JR., RICHARD W. RADCLIFFE, FRANCIS L. VEEDER, and AMERICAN INVESTORS FUND, INC.,

Defendants.

Petitions for rehearing containing suggestions that the action be reheard in banc having been filed herein by counsel for the defendant-appellant, John Currier, and by counsel for defendants-appellants, George A. Chestnutt, Jr., Warren K. Greene, Stanley L. Sabel and American Investors Corporation,

Upon consideration by the panel that heard the appeal, it is ORDERED that said petitions for rehearing are DENIED.

It is further noted that the suggestions for rehearing in banc have been transmitted to the judges of the court in regular active service and to any other judge on the panel that heard the appeal and that no such judge has requested that a vote be taken thereon.

A. DANIEL FUSARO

.....

A. Daniel Fusaro
Clerk
BY FRANCIS X. GINDHART
Chief Deputy Clerk

ROSALIND FOGEL AND GERALD FOGEL,

Plaintiffs-Appellees,

v.

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, WARREN K. GREENE, STANLEY L. SABEL, AMERICAN INVESTORS CORPORATION, and CHESTNUTT CORPORATION,

Defendants-Appellants,

and

FRANK G. FOWLER, JR., RICHARD W. RADCLIFFE, FRANCIS L. VEEDER, and AMERICAN INVESTORS FUND, INC.,

Defendants.

Nos. 4, 5, Dockets 80-7800, 80-7804.

UNITED STATES COURT OF APPEALS,
Second Circuit.

Argued Oct. 7, 1981.

Decided Dec. 17, 1981.

Before FEINBERG, Chief Judge, and FRIENDLY and MESKILL, Circuit Judges.

FRIENDLY, Circuit Judge:

In *Fogel* v. *Chestnutt*, 533 F.2d 731 (2 Cir. 1975) (*Fogel I*), *cert. denied*, 429 U.S. 824, 97 S.Ct. 77, 50 L.Ed.2d 86 (1976), we reversed a judgment of Judge Wyatt in the District Court, 383 F.Supp. 914, for the Southern District of New York which dismissed on the merits a derivative action in which two stockholders of American Investors Fund, Inc. (the Fund) sought to recover brokerage commissions and like amounts which allegedly could have been recaptured for the benefit of the Fund if it or an affiliate had become a member of the National Association of Security Dealers, Inc. (NASD) and the Philadelphia-Baltimore-Washington Stock Exchange (PBW). The defendants were American Investors Corporation which had been investment adviser and manager of the Fund until July, 1966, and its successor Chestnutt Corporation, to which we shall refer collectively as the Adviser,

and four of its directors. These were George A. Chestnutt, Jr., who had been the chief figure in both the Fund and the Adviser and owned 47% of the latter's stock; Stanley L. Sabel, senior vice president, secretary and a director of the Fund, and vice president, secretary, general counsel and a director of the Adviser, and owner of 16% of its stock; Warren K. Greene, vice president and a director of the Fund, and vice president of the Adviser, and owner of .4% of its stock; and John Currier, a director of the Fund and owner of 2% of the Adviser's stock.

In agreement with the result although not with all the reasoning in the well-known decision of the First Circuit in *Moses* v. *Burgin*, 445 F.2d 369, *cert. denied*, 404 U.S. 994, 92 S.Ct. 532; 30 L.Ed.2d 547 (1971), we held the defendants liable because of their failure adequately to investigate the possibilities of recapture and make a full report to and secure informed and deliberate consideration of this by the independent directors, see 533 F.2d at 749-50, in violation of the Investment Company Act (ICA), contrast *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2 Cir.), *cert. denied*, 434 U.S. 934, 98 S.Ct. 421, 54 L.Ed.2d 293 (1977). We remanded the case to the district court for the determination of damages, with certain instructions on that subject, 533 F.2d at 755-57, hereafter discussed. Familiarity with the opinion in *Fogel I* will be assumed.

The district court referred the determination of damages to Magistrate Schreiber as a special master. He received testimony from an expert witness for plaintiffs and eleven witnesses, several of them experts, for the defendants. The Magistrate largely sustained plaintiffs' claims with respect to recapture of brokerage commissions on business actually transacted by the Adviser on the PBW, of tender offer fees that would have been payable if the Adviser or an affiliate had become a member of the NASD, and of underwriting discounts, commissions and allowances obtainable by having a brokerage affiliate become a member of the underwriting or selling group. However, he rejected plaintiffs' claims with respect to the recapture of commissions for reciprocal

brokerage, a subject with which, as was also the case with underwriting discounts, our opinion in *Fogel I* did not specifically deal. After deducting added expenses to which the Adviser would have been subject, the Magistrate arrived at a total of damages for the years 1967-74 of $349,013.04 to which there was to be added interest at the legal rates in effect at the end of each year.

Exceptions were filed by both sides and were disposed of by the district court in an opinion reported in 493 F.Supp. 1192 (1980). The district judge accepted, with some downward modifications, the recommendations of the Magistrate favorable to plaintiffs. However, he sustained plaintiffs' exceptions to the large item relating to reciprocal commissions. The result was a judgment in the amount of $3,919,220, consisting of $2,370,357 of principal and $1,548,863 of interest.

Despite our recognition that defendant Currier was "a special case" and our suggestion that "equity would suggest the imposition of primary liability on the Adviser, which profited from the failure to recapture", 533 F.2d at 750, the attorney, Clendon H. Lee, who had represented all the defendants in *Fogel I*, continued to do so in the district court after remand. After noting the relevant passage on this subject in *Fogel I*, the Magistrate said:

> Because all defendants were represented by the same attorney during these proceedings, and no proof of individual responsibility was introduced, a finding of degrees of fault of the individual defendants is not feasible.

The district court upheld this and directed that judgment be entered holding all defendants jointly and severally liable in the full amount, 493 F.Supp. at 1204.

All defendants have appealed. The defendants other than Currier, while continuing to be represented by Mr. Lee, retained new attorneys who, in addition to challenging the amount of the award, argue that no award was permissible since in their view there is no private cause of action for damages for violations of the ICA other than that provided in § 30(f) which admittedly is

not applicable here,[1] and the one created by the addition of § 36(b) in 1970.[2] We shall sometimes refer to the defendants so

1. This is a short-swing profits provision corresponding to § 16(b) of the Securities Exchange Act of 1934.

2. This provides:

> For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:
>
> (1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.
>
> (2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.
>
> (3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payment received from such investment company, or the security holders thereof, by such recipient.
>
> (4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

represented as "defendants" or "appellants". Currier at long last has retained independent counsel who, while joining in the arguments made on behalf of the other defendants, place particular emphasis on the unfairness of subjecting Currier, who was not a part of the management group, to exposure to so large a judgment.[3] In Part I of this opinion we shall discuss defendants' attempt to raise at this stage of the case the issue of the existence of a private cause of action for damages under the ICA. Part II will deal with the issues raised in respect of damages. In Part III we shall discuss Currier's arguments for treatment as a "special case".

I.
Liability

Our opinion in *Fogel I* necessarily assumed that an adviser's and a director's breach of fiduciary duty under the ICA gave rise to a private cause of action for damages. Congress had sought to deal with the problem that the relationship between a mutual fund and its investment adviser and underwriters was rife with opportunities for self-dealing, see *Moses* v. *Burgin, supra*, 445 F.2d at 376, by requiring a minimum proportion of disinterested directors, § 10(a), and by vesting them with special responsibilities with respect to contracts between the fund and advisers and underwriters, § 15(c). In *Fogel I*, 533 F.2d at 745, we agreed with Chief Judge Aldrich, writing for the First Circuit in *Moses* v. *Burgin, supra*, 455 F.2d at 377, that

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(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78a of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

3. Plaintiffs have assured Currier that execution will not be sought against him until efforts to collect the judgment from other defendants have been exhausted. Brief, pp. 13-14.

> If management does not keep these directors informed they will not be in a position to exercise the independent judgment that Congress clearly intended.

There was no occasion for us to discuss the existence of a private cause of action to enforce this duty since we had long since decided the point in *Brown* v. *Bullock*, 294 F.2d 415 (2d Cir. 1961), and, doubtless in view of this and the Supreme Court's decision in *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 84 S.Ct. 1555, 12 L.Ed.2d 423 (1964) (§ 14 of Securities Exchange Act), which seemingly confirmed it, defendants' counsel did not raise the issue in brief or argument or in his petition for reconsideration.[4]

Defendants now argue that we—and they—were mistaken in the basic assumption that plaintiffs were entitled to recover if they could show violations of the ICA by the defendants, and that decisions of the Supreme Court, particularly *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979); see also *Cort* v. *Ash*, 422 U.S. 66, 95 S.Ct. 2080, 45 L.Ed.2d 26 (1975); *Piper* v. *Chris-Craft Industries, Inc.*, 430 U.S. 1, 97 S.Ct. 926, 51 L.Ed.2d 124 (1977); *Touche Ross & Co.* v. *Redington*, 442 U.S. 560, 99 S.Ct. 2479, 61 L.Ed.2d 82 (1979); and *Kissinger* v. *Reporters Committee for Freedom of the Press*, 445 U.S. 136, 100 S.Ct. 960, 63 L.Ed.2d 267 (1980), although not dealing with the ICA, compel the conclusion that no implied private causes of action for damages exist under that statute. In addition to disputing defendants' contention, plaintiffs assert that we need not and should not reach its merits. For this they rely both on the preclusive effect of the pretrial order and on the principal of the law of the case.

Defendants' initial response is that the existence of an implied cause of action under the ICA is jurisdictional and hence may be raised at any time. This argument is simply one more instance of

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4. A feeble reference to the point was made in the petition for *certiorari*, p. 30, where *Cort* v. *Ash*, 422 U.S. 66, 95 S.Ct. 2080, 45 L.Ed.2d 26 (1975), which had been handed down three months before *Fogel I* was argued and six months before it was decided, was cited.

the fallacy, to which courts as well as counsel have not been immune, of confusing the question whether a court has jurisdiction with the question whether a complaint states a claim upon which relief can be granted.[5]

The complaint based jurisdiction on the ICA, as well as the Investment Advisers Act of 1940 and the Securities Exchange Act of 1934. It thus stated a claim arising under a law of the United States, of which the district court had jurisdiction under 28 U.S.C. § 1331(a), as well at § 44 of the ICA. If in fact the statutes relied upon by the plaintiffs did not authorize recovery of damages because of violations of the sort alleged, the complaint failed to state a claim upon which relief can be granted and was subject to dismissal upon that ground. However, as defendants would have been the first to assert if they had prevailed in that position and plaintiffs brought another action for the same relief, the dismissal would have been upon the merits and not for lack of jurisdiction.

This lesson has been taught as often in decision as it has been ignored in argument and dicta. Justice Holmes preached it long ago in *The Fair* v. *Kohler Die and Specialty Co.*, 228 U.S. 22, 25, 33 S.Ct. 410, 411, 57 L.Ed. 716 (1913), when he wrote:

> [W]hen the plaintiff bases his cause of action upon an act of Congress jurisdiction cannot be defeated by a plea denying the merits of this claim. It might be defeated, no doubt, in a case depending on diversity of citizenship by a plea to the citizenship of parties. *Interior Construction and Improvement Co.* v. *Gibney*, 160 U.S. 217, 219, 16 S.Ct. 272, 272-73, 40 L.Ed. 401. We are speaking of a

5. The confusion is well illustrated by paragraphs 22 and 23 of defendants' answer:

> 22. The court lacks jurisdiction over the subject matter of this action in that there is no . . . claim of wrong or injury upon which relief can be granted.
>
> 23. The complaint fails to state a claim under the Constitution, Laws or Treaties of the United States, or upon which relief can be granted under the Investment Company Act of 1940 (15 U.S.C. § 80a-1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. § 80b-1 et seq.), and the Securities Exchange Act of 1934 (15 U.S.C. § 78a et seq.) . . .

> case where jurisdiction is incident to a Federal statutory cause of action. Jurisdiction is authority to decide the case either way. Unsuccessful as well as successful suits may be brought upon the act, and a decision that a patent is bad, whether on the facts or the law, is as binding as one that it is good. See *Fauntleroy* v. *Lum*, 210 U.S. 230, 235, 28 S.Ct. 641, 642, 52 L.Ed. 1039. No doubt if it should appear that the plaintiff was not really relying upon the patent law for his alleged rights, or if the claim of right were frivolous, the case might be dismissed. In the former instance the suit would not really and substantially involve a controversy within the jurisdiction of the court, *Excelsior Wooden Pipe Co.* v. *Pacific Bridge Co.*, 185 U.S. 282, 287, 288, 22 S.Ct. 681, 683, 46 L.Ed. 910, and in the latter the jurisdiction would not be denied, except possibly in form. *Deming* v. *Carlisle Packing Co.*, 226 U.S. 102, 109, 33 S.Ct. 80, 83, 57 L.Ed. 140. But if the plaintiff really makes a substantial claim under an act of Congress there is jurisdiction whether the claim ultimately be held good or bad.

Justice Black reaffirmed the principle in *Bell* v. *Hood*, 327 U.S. 678, 682-83, S.Ct. 773, 776, 90 L.Ed. 939 (1946). Dealing with a case where the district court had dismissed for want of jurisdiction an action in which the plaintiff sought damages for violations of constitutional rights by FBI agents, his opinion stated:

> Jurisdiction, therefore, is not defeated as respondents seem to contend, by the possibility that the averments might fail to state a cause of action on which petitioners could actually recover. For it is well settled that the failure to state a proper cause of action calls for a judgment on the merits and not for a dismissal for want of jurisdiction. Whether the complaint states a cause of action on which relief could be granted is a question of law and just as issues of fact it must be decided after and not before the court has assumed jurisdiction over the controversy. If the court does later exercise its jurisdiction to

> determine that the allegations in the complaint do not state a ground for relief, then dismissal of the case would be on the merits, not for want of jurisdiction. *Swafford* v. *Templeton*, 185 U.S. 487, 493, 494, 22 S.Ct. 783, 785-786, 46 L.Ed. 1005; *Binderup* v. *Pathe Exchange*, 263 U.S. 291, 305-308, 44 S.Ct. 96, 98-99, 68 L.Ed. 308. The previously carved out exceptions are that a suit may sometimes be dismissed for want of jurisdiction where the alleged claim under the Constitution or federal statutes clearly appears to be immaterial and made solely for the purpose of obtaining jurisdiction or where such a claim is wholly insubstantial and frivolous. (Footnote omitted.)[6]

Justice Jackson illuminated the distinction, which the court of appeals had failed to note, in *Montana-Dakota Utilities Co. v. Northwestern Public Service Co.*, 341 U.S. 246, 249, 71 S.Ct. 692, 694, 95 L.Ed. 912 (1951). Chief Justice Burger did so again in *Duke Power Co. v. Carolina Environmental Study Group, Inc.*, 438 U.S. 59, 71-72, 98 S.Ct. 2620, 2629-30, 57 L.Ed.2d 595 (1978).

Burks v. *Lasker*, 441 U.S. 471, 99 S.Ct. 1831, 60 L.Ed. 2d 404 (1979), is even closer to our case. The Court was there dealing with the applicability of the business judgment rule to a private right of action asserted under the ICA and the Investment Advisers Act. After noting that the courts below assumed that an implied right of action existed under each act, the Court said that it would assume without deciding that respondents had such causes of action—a course which would have been improper if in fact the lower courts had no jurisdiction. The Court's awareness of this was manifested in fn. 5:

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6. The Court rejected the position taken by Chief Justice Stone and Justice Burton in dissent, 327 U.S. at 685-86, 66 S.Ct. at 777-78, that where "neither the constitutional provision nor any act of Congress affords a remedy to any person, the mere assertion by a plaintiff that he is entitled to such a remedy cannot be said to satisfy jurisdictional requirements." This is the precise position taken by the defendants here.

> The question whether a cause of action exists is not a question of jurisdiction, and therefore may be assumed without being decided.

It cited for this *Mt. Healthy City Board of Education* v. *Doyle*, 429 U.S. 274, 279, 97 S.Ct. 568, 572, 50 L.Ed.2d 471 (1977), which was to substantiate the same effect.

[3] Commendably recognizing that the footnote in *Burks* v. *Lasker* "is difficult to distinguish", Reply Brief p. 2, defendants cite a sentence from *Kissinger* v. *Reporters Committee for Freedom of the Press*, 445 U.S. 136, 149-50, 100 S.Ct. 960, 968-69, 63 L.Ed.2d 267 (1980) where the Court said in deciding that there is no private right of action under the Records and Records Disposal Acts, 44 U.S.C. §§ 2901 *et seq.*, 3303 *et seq.*:

> Congress has not vested federal courts with jurisdiction to adjudicate that question upon suit by a private party.

This shows only that the Supreme Court in using "jurisdiction" language can make the same mistake for which it has repeatedly chided lower courts. It is impossible to believe that the Court intended by a mere stroke of the pen to obliterate a distinction that it had consistently drawn for many decades. Rather this was another instance where, as Justice Jackson observed in *Montana-Dakota Utilities Co.* v. *Northwestern Public Service Co.*, *supra*, 341 U.S. at 249, 71 S.Ct. at 694:

> As frequently happens where jurisdiction depends on subject matter, the question whether jurisdiction exists has been confused with the question whether the complaint states a cause of action.

As Justice Frankfurter once said, " '[j]urisdiction' competes with 'right' as one of the most deceptive of legal pitfalls." *City of Yonkers* v. *United States*, 320 U.S. 685, 695, 64 S.Ct. 327, 333, 88 L.Ed. 400 (1944) (dissenting). Thus concluding that the question whether there is an implied cause of action for damages

under the ICA goes to the merits rather than to jurisdiction, we pass on to plaintiffs' contentions with respect to the effect of the pretrial order and the principle of the law of the case.

On September 4, 1973, the district judge entered a pretrial order pursuant to F.R.Civ.P. 16. The order began by reciting that the pleadings had been deemed amended and supplemented by plaintiffs' supplemental complaint and that "[p]laintiffs abandon no issues raised in this supplemental pleading." (A-71) this was followed by several pages of stipulated facts. Next came a listing of the contentions of plaintiffs and defendants. The latter made no mention of any claim, such as may charitably be deemed to have been asserted in paragraphs 22 and 23 of the answer, see note 5, that the ICA did not authorize private recovery of damages for violations, although defendants did raise numerous issues of law, including an assertion (A-77e) that "[a]t all relevant times defendants and all directors have complied in all respects with the provisions of the Investment Company Act. . . ." the order then proceeded to list materials on which the parties would rely and witnesses whom they expected to call.

Plaintiffs' argument that the pretrial order constituted an abandonment of any defense that there is no private cause of action for violation of the ICA other than those provided in § 30(f) and § 36(b) is forceful. F.R.Civ.P. 16 directs that the pretrial order "when entered controls the subsequent course of action, unless modified at the trial to prevent manifest injustice." We find no merit in defendants' argument that Rule 16 applies only to issues of fact. Clause (1) speaks broadly of "[t]he simplification of the issues", and there can be no better way to do this than to abandon a legal defense which, if sound, would eliminate any occasion for trial. In *United States* v. *Hougham*, 364 U.S. 310, 315, 81 S.Ct. 13, 17, 5 L.Ed.2d 8 (1960), the Court spoke of the pretrial order there under consideration as having "conclusively established the issues of fact and law in the case". In *Fogel I* we applied this very pretrial order to preclude an

argument by defendants that we should make a "threshold" disposition without reaching the merits, on the ground of plaintiffs' failure to allege with sufficient particularity their efforts to obtain action from the directors or their reasons for failing to do so, as required by F.R.Civ.P. 23.1. We held that point to have been abandoned since, although the answer had denied the paragraph of the complaint which sought to show compliance with F. R. Civ. P. 23.1, 'no issue of non-compliance was included in defendants' 17 contentions listed in the pretrial order." Hence we regarded "the point as having been abandoned." 533 F.2d at 738 n.7. We fail to see why the same logic should not apply to paragraphs 22 and 23. It would have been a simple matter to have included these in the list of contentions in the pretrial order or to reserve them as plaintiffs did with respect to allegations of their complaint. The cases cited by defendants, *Laird* v. *Air Carrier Engine Service, Inc.*, 263 F.2d 948, 953-54 (5 Cir. 1959), and *Padovani* v. *Bruchhausen*, 293 F.2d 546, 548 (2 Cir. 1961), are not to the contrary.

If there is any answer to plaintiffs' contentions with respect to the pretrial order, it must be rather that defendants' abandonment of the no private cause of action defense, if we generously assume that paragraphs 22 and 23 of the answer adequately alleged this, was due to a justified belief that assertion of this would have been futile in view of our decision in *Brown* v. *Bullock, supra*, 294 F.2d 415, the uncontested assumption of an implied cause of action in *Rosenfeld* v. *Black*, 445 F.2d 1337 (2 Cir. 1971), *cert. denied*, 409 U.S. 802, 93 S.Ct. 24, 34 L.Ed.2d 62 (1972)[7] the First Circuit's decision in *Moses* v. *Burgin, supra*, 445 F.2d 369, and the view with respect to implied causes of action under the securities laws then generally prevailing in light of the Supreme Court's decision in *J. I. Case Co.* v. *Borak, supra*, 377 U.S. 426, 84 S.Ct. 1555, 12 L.Ed.2d 423. Rule 16 authorizes a district court to modify a pretrial order "at the trial to prevent manifest injustice." We assume a court of appeals has

7. No question as to the existence of an implied cause of action had been raised by the distinguished counsel representing the defendants in *Rosenfeld* and our opinion there as in *Fogel I* did not discuss the subject.

similar power, although the party seeking relief must present a much stronger case since the adverse party has been subjected to the burden of a trial, and a still stronger one when an earlier appeal and extensive proceedings with respect to damages have occurred. Defendants scarcely meet this test—particularly since the 1970 amendment to § 36(b) which provides the basis for their principal argument against an implied cause of action under the ICA was available to them at the time of the pretrial conference in 1973 as a ground for seeking to distinguish *Brown* v. *Bullock*, which antedated 1970, and *Rosenfeld* v. *Black*, which did not involve the receipt of advisory fees, the subject matter of § 36(b).

Defendants are also precluded from now litigating the existence of an implied cause of action for damages for their violations of the ICA because of the principle of the law of the case. We begin by dismissing defendants' contention that this principle is inapplicable because in *Fogel I* we did not expressly affirm the existence of a private cause of action. The principle applies as well to everything decided by necessary implication. See, *e.g.*, *Walston* v. *School Board*, 566 F.2d 1201, 1205 (4 Cir. 1977); *Terrell* v. *Household Goods Carriers' Bureau*, 494 F.2d 16, 19 (5 Cir.), *cert. denied*, 419 U.S. 987, 95 S.Ct. 246, 42 L.Ed.2d 260 (1974). It would be absurd that a party who has chosen not to argue a point on a first appeal should stand better as regards the law of the case than one who had argued and lost.

However, in applying the principle of the law of the case, we must give serious consideration to defendants' contention that Supreme Court decisions subsequent to *Fogel I* have demonstrated that the assumption on which we acted without contest from them was in error. We unhesitatingly accept that, as we stated in *Zdanok* v. *Glidden Co.*, 327 F.2d 944, 951 (2 Cir. 1964), "if, before a case in a district court has proceeded to final judgment, a decision of the Supreme Court demonstrates that a ruling on which the judgment would depend was in error, no principle of 'the law of the case' would warrant a failure on our part to correct the ruling." Defendants' problem is with the requirement of demonstration. It is not enough, as explained by

us in *Zdanok, supra*, 327 F.2d at 951-53, and by Judge Magruder in *White* v. *Higgins*, 116 F.2d 312, 317 (1 Cir. 1940), that defendants could now make a more persuasive argument against the existence of an implied cause of action than we would have thought likely when the case was last here. As Judge Magruder said, "mere doubt on our part is not enough to open the point for full consideration." The law of the case will be disregarded only when the court has "a clear conviction of error" with respect to a point of law on which its previous decision was predicated, *Zdanok* v. *Glidden, supra*, 327 F.2d at 953, citing *Johnson* v. *Cadillac Motor Car Co.*, 261 F. 878, 886 (2 Cir. 1919). We have no such clear conviction that a private action will not lie under the ICA for an omission of the Adviser and interested directors to communicate fully and frankly to disinterested directors with respect to the Adviser's refusal, in furtherance of its own interests, to take action financially beneficial to the Fund which had been repeatedly called to the attention of the Adviser by the SEC and had been taken by other funds.

Appellants must concede that the Supreme Court has not yet passed on the question whether private causes of action for damages can be implied from the ICA. The closest approach that has been cited to us is *Transamerica Mortgage Advisors, Inc.* v. *Lewis*, 444 U.S. 11, 100 S.Ct. 242, 62 L.Ed.2d 146 (1979), which held that no private cause of action for damages can be implied from the Investment Advisers Act of 1940, although a cause of action for equitable relief could be implied. That distinction rested on a combination of two factors: (1) that § 215 of the Act provided only that contracts made in violation of its terms "shall be void"—a term ordinarily taken to mean merely that the person with power to avoid the contract "may resort to a court to have the contract rescinded and to obtain restitution of consideration paid", 444 U.S. at 18, 100 S.Ct. at 246, and (2) that the jurisdictional section. § 214, earlier drafts of which had incorporated by reference a provision of the Public Utility Holding Company Act of 1935 giving the federal courts jurisdiction "of all suits in equity and actions at law brought to enforce any liability or

duty created by" the statute, had been changed during the course of enactment to the final version under which the jurisdiction was limited to "suits in equity to enjoin any violation", omitting any reference to actions at law or to liability. 444 U.S. at 21-22, 100 S.Ct. at 247-48[8].

The question of implying a cause of action for damages for violation of the ICA differs in many ways. The two factors expressly relied on in *Transamerica* to negate a private cause of action for damages do not exist; the jurisdictional section, § 44, like similar sections in other securities laws, *e.g.*, § 27 of the Securities Exchange Act, grants the district courts jurisdiction "of all suits in equity and actions at law brought to enforce any liability or duty created by, or to enjoin any violation of this title or the rules, regulations or orders thereunder." Section 1(b) of the ICA declares "that the national public interest and the interest of investors are adversely affected—

> (2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other

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8. The Court noted, 444 U.S. at 22-23 n. 13, 100 S.Ct. at 248-249 n. 13,

> In 1975, the Commission submitted a proposal to Congress that would have amended § 214 to extend jurisdiction, without regard to the amount in controversy, to "actions at law" under the Act. See S. 2849, 94th Cong., 2d Sess., § 66 (1976). The Commission was of the view that the amendment also would confirm the existence of a private right of action to enforce the Act's substantive provisions. See hearings on S. 2849 before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, 94th Cong., 2d Sess., 17 (1976); Hearings on H.R. 12981 and H.R. 13737 before the Subcommittee on Consumer Protection and Finance of the House Committee on Interstate and Foreign Commerce, 94th Cong., 2d Sess., 36-37 (1976). The Senate Committee reported favorably on the provision as proposed by the Commission, but the bill did not come to a vote in either House.

> investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders. . . .

The section concluded by declaring that

> the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.[9]

The *Transamerica* Court also noted, 444 U.S. at 20, 100 S.Ct. at 247,

> Under each of the securities laws that preceded the Act here in question, and under the Investment Company Act of 1940 which was enacted as companion legislation, Congress expressly authorized private suits for damages in prescribed circumstances.

In contrast to the three court of appeals decisions, all of very recent date, see 444 U.S. at 14 n.4, 100 S.Ct. at 244 n.4, sustaining the availability of a private cause of action under the Investment Advisers Act, the cases in the courts of appeals upholding the private cause of action for damages for violation of the ICA go back to our decision in *Brown* v. *Bullock, supra,* in 1961, and include the Third Circuit's 1963 decision in *Taussig* v. *Wellington Fund, Inc., 313 F.2d 472, 476, cert. denied,* 374 U.S. 806, 83 S.Ct. 1693, 10 L.Ed.2d 1031 (1963); the First Circuit's 1964 decision in *Levitt* v. *Johnson,* 334 F.2d 815 (1964), *cert. denied,* 379 U.S. 961, 85 S.CT. 649, 13 L.Ed.2d 556 (1965); the Tenth Circuit's 1968 decision in *Esplin* v. *Hirschi,* 402 F.2d 94, 103 (1968), *cert. denied,* 394 U.S. 928, 89 S.Ct. 1194, 22 L.Ed.2d 459 (1969), and numerous other decisions of these courts of appeals, several subsequent to the 1970 amendment of

9. In his elaborate opinion in *Brown* v. *Bullock, 194 F.Supp. 207, 218 (S.D.N.Y.), aff'd,* 294 F.2d 415 (2 Cir. 1961), Judge Herlands said of this statement "[t]his is more than a mere exordium. It is a directive to the courts."

§ 36(b) on which defendants rely as negating an implied cause of action.[10] The sole exception to the recognition of an implied cause of action for damages under the ICA was *Brouk* v. *Managed Funds, Inc.*, 286 F.2d 901 (8 Cir.), *cert. granted*, 366 U.S. 958, 81 S.Ct. 1921, 6 L.Ed.2d 1252 (1961), judgment vacated and case remanded with instructions to dismiss, 369 U.S. 424, 82 S.Ct. 878, 8 L.Ed.2d 6 (1962), pursuant to a settlement, see 378 F.2d at 793 n.6.[11] However, in *Greater Iowa Corp.* v. *McLendon*, 378 F.2d 783, 793 (8th Cir. 1967), although not finding it necessary to decide the point, the Eighth Circuit, after quoting from *J.I. Case Co.* v. *Borak*, *supra*, 377 U.S. at 433, 84 S.Ct. at 1560, said that:

> In coming down strongly in favor of courts implying private civil remedies where none are expressed, the strong indications are, that if given the opportunity, the Supreme Court would also find an implied civil liability in the Investment Company Act and thereby overrule our opinion in *Brouk*.

While, as defendants contend, this nose count is not quite so impressive as that with respect to Rule 10b-5 when the Supreme Court upheld an implied cause of action in *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 92 S.Ct. 165, 30 L.Ed.2d 128 (1971), it is impressive enough.[12] Defendants argue that none of the cases upholding private causes of action under the securities laws existed in 1940 when the ICA was enacted, but neither were there such decisions when §§ 10(b) and

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10. Although defendants are correct in arguing that *Herpich* v. *Wallace*, 430 F.2d 792, 815-16 (5 Cir. 1970), did not explicitly decide the question of a private cause of action for damages under the ICA, the discussion leaves little doubt that the Fifth Circuit would have joined the ranks if decision had been needed.

11. In fact, *Brouk* could have been and was in part rested on much narrower grounds. See 286 F.2d at 912, 918; *Brown* v. *Bullock*, 194 F.Supp. at 247.

12. What is perhaps most significant about the *Superintendent of Insurance* case in this context is that the entire discussion of the existence of an implied cause of action was a five-line footnote, 404 U.S. at 13 n.9, 92 S.Ct. at 169 n.9.

14 of the Securities Exchange Act of 1934 were adopted. Actually the case for an implied cause of action under the ICA is stronger than were those in *Superintendent of Insurance* as regards Rule 10b-5 and in *J.I. Case* as regards § 14 since the 1934 Act had not been the subject of extensive overhaul when those cases were decided, whereas the ICA was significantly amended in 1970 and again in 1975, long after the implied cause of action under it had been recognized. At least this is true unless defendants are right in asserting that the creation in 1970 of a new express remedy in § 36(b) shows a Congressional intention to negate all private causes of action which the courts of appeals had recognized as regards other sections of the ICA.

Although we do not find it necessary to decide the point, we do think § 36(b) was intended to negate implied causes of action which the courts have found under sections of the Act other than § 36. Indeed, we are already on record to this effect. See *Tannenbaum* v. *Zeller, supra,* 552 F.2d at 417. The problem to which § 36(b) was addressed was that with which the SEC had dealt in pages 125-49, 154 of its Report on Public Policy Implications of Investment Company Growth (PPI), H.R. Rep. No. 2337, 89th Cong., 2d Sess. (1966). This was that advisers' fees, generally stated as a percentage of the market value of the managed assets, which had been altogether reasonable when a fund was launched, may have become unreasonably high when the fund grew to enormous size. See Jennings & Marsh, Securities Regulation: Cases and Materials, 1394, *et seq.* (4th ed. 1977). Section 36 of the 1940 Act had proved to be an ineffective vehicle for dealing with this problem since it expressly authorized action only by the SEC and imposed a very high standard of proof, to wit, "gross misconduct or gross abuse of trust". Although our decision in *Brown* v. *Bullock* sustained a complaint with respect to advisers' fees as pleading causes of action under other sections of the ICA, it was unlikely that a plaintiff could prove them. See Jennings & Marsh, *supra,* at 1395-96. Actions in state courts were likewise ineffective since those courts required objecting stockholders to show corporate "waste". *Id.* at 1396, citing the

well-known case of *Saxe v. Brady*, 40 Del. Ch. 474, 184 A.2d 602 (1962); PPI at 133-38; Sen. Rep. No. 91-184, 91st Cong. 2d Sess. 5, *reprinted in* [1970] U.S. Code Cong. & Admin. News 4897, 4901. In order to enable the courts to deal more effectively with this problem, the SEC proposed a bill amending the Act to provide that advisory fees must be "reasonable" irrespective of approval of the advisory contract by the directors or shareholders, and that shareholders as well as the SEC should be entitled to sue to enforce the new standard. Surely the last thing the SEC intended was the abolition of implied causes of action which the courts had recognized under other sections of the ICA, as the SEC had consistently favored, *e.g.*, in its *amicus* brief to this court in *Brown* v. *Bullock*. That § 36(b) was addressed only to cases where the advisory fee was attacked as such is demonstrated by the provision in § 36(b)(3) whereby any recovery is limited to the amount of compensation received.

As recounted in Jennings & Marsh, *supra*, at 1396-97, the mutual fund industry bitterly opposed the bill which "languished for over three years" until "largely at the prodding of Congress, the SEC and industry representatives reached a compromise which ultimately was embodied as an amendment to Section 36 of the Investment Company Act." The authors state, at 1397, that "The language of subsection (b) is a lesson in the art of studied ambiguity in drafting of statutes." We might agree with defendants that § 36(b), with the severe limitations of subsection (3), constitutes the exclusive remedy insofar as a private claim alleges solely that compensation of an adviser subsequent to June 14, 1972, the effective date of § 36(b), is so excessive in the sense of surpassing any reasonable relation to the services rendered that its payment is a breach of fiduciary duty. However, there is no reason to conclude that by adopting a modified version of the SEC's proposal to afford and express private remedy with respect to one problem as to which the 1940 Act had proved ineffective, the 1970 Congress meant to withdraw the implied private cause of action in other areas which had been recognized over the previous decade by four courts of appeals, with the lone dissenting

court having indicated strong willingness to reconsider. *Tannenbaum* v. *Zeller, supra,* 552 F.2d at 417. The present action is not one "for breach of fiduciary duty in respect of . . . compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person" to which § 36(b) applies. It is rather for breach of the fiduciary duty to make a full disclosure to the independent directors of opportunities available to the Fund, even though a motivation for and the effect of the nondisclosure were to increase the gross fees by stimulating growth of the Fund and the net fees both by this and by obtaining from brokers "research" services which the Adviser would otherwise have had to supply at its own cost.

We are thus far from having "a clear conviction of error", see *Zdanok* v. *Glidden Co., supra,* 327 F.2d at 953, in the assumption in *Fogel I,* unchallenged at the time, that a private cause of action lay in respect of plaintiffs' complaints. In adopting a statute intended as a thorough and pervasive regulation of the investment company industry, in part because of the inadequacies of the 1933 and 1934 Acts "to cope with the grave abuses and evils that had developed in some quarters of the investment company business", *Brown* v. *Bullock, supra,* 194 F.Supp. at 217, and in the face of the declaration in § 1, it seems to us highly unlikely that Congress intended that, save for suits to recover short-swing profits, § 30(f), enforcement should be solely the task of the SEC and of the criminal law, and that injured investors should have no recourse in a federal court. While we recognize that the question of the existence of a private cause of action under the ICA has become more debatable than we or the defendants thought in 1975, we thus perceive no justification for departing from the law of the case.[13]

13. *Citing Crane Co.* v. *American Standard, Inc., (Crane III),* 603 F.2d 244 (2 Cir. 1979), appellants argue that departure by a court of appeals from the law of the case may be justified even in the absence of a Supreme Court decision directly demonstrating that the previous ruling of the court of appeals was in error. We have no quarrel with the argument but find it inapplicable. We held in *Crane III* that our ruling in Crane I *Crane Co.* v. *Westinghouse Air Brake Co.,* 419 F.2d 787 (2 Cir. 1969), *cert. denied,* 400 U.S. 822, 91 S.Ct. 41, 27 L.Ed.2d 50 (1970), that Crane, a tender offeror, possessed a cause of action for

II.
DAMAGES

As noted, we ended or opinion in *Fogel I* by saying, 533 F.2d at 755, that:

> In remanding to the district court for the determination of damages, we are bound to give guidance as we can.

We began by fixing the periods during which liability for various sorts of recapture should exist; appellants voice no complaints with respect to these. We then said, 533 F.2d at 755-57:

> The amount for which defendants are to be held liable will depend on the attempt, difficult but ineluctable, of seeking to find what would have been. In deciding this we must mediate between the two principles, given expression in cases arising under the antitrust laws, that while "a defendant whose wrongful conduct has rendered difficult ascertainment of the precise damages suffered by the plaintiff, is not entitled to complain that they cannot be measured with the same exactness and precision as would otherwise be possible," *Eastman Kodak Co.* v. *Southern Photo Materials Co.*, 273 U.S. 359, 379 [47 S.Ct. 400, 405, 71 L.Ed. 684]. . . (1927), yet recovery "cannot be had unless it is shown, that, as a result of defendants' acts,

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monetary damages under §§ 9(e) and 10(b) of the Securities Exchange Act and Rule 10b-5, could not be sustained in the aftermath of *Piper v. Chris-Craft Industries, Inc.*, 430 U.S. 1, 97 S.Ct. 926, 51 L.Ed2d 124 (1977), which actually dealt with § 14(e). However, as the opinion carefully pointed out, there was simply no rational basis for thinking that the Supreme Court would be more willing to imply a cause of action for a defeated offeror under the general provisions of Rule 10b-5 than under § 14(e), see 603 F.2d at 249. Hence the *Piper* case was effectively controlling. Here, as we have sought to show, it is far from certain that the Supreme Court would hold that plaintiffs had no implied cause of action for damages under the ICA as enacted or that, if they did, their rights were destroyed by the 1970 amendment creating § 36(b). Implied causes of action under the ICA can quite readily be assimilated to those still recognized under § 10-b and Rule 10b-5 and § 14 of the Securities Exchange Act rather than held to be governed by the *Tranamerica* holding under the Investment Advisers Act. Whether they will be, only time will tell.

damages in some amount susceptible of expression in figures resulted." *Keogh v. Chicago & Northwestern Ry.*, 260 U.S. 156, 165 [43 S.Ct. 47, 50, 67 L.Ed. 183] . . . (1922). The *Moses* court held the defendants (other than unaffiliated directors) liable for Crosby's failure to avail itself of NASD recapture (the only method there being pressed) on all transactions on the PBW and Pacific Coast Exchanges, since any lesser measure of recovery would mean that the business judgment defense, although foreclosed on the issue of liability because of lack of effective disclosure to unaffiliated directors, would be entering through the back door. In a footnote, 445 F.2d at 385, n.25, the court added that the district court "may well find that at a reasonable interval after a final determination to bank give-ups should have been made," during which interval the unfeasibility of achieving give-ups except on the PBW and Pacific Coast Exchanges might have been ascertained," [sic] proper practice would have been, consistent with best execution, to make as many transactions as possible on the two favorable exchanges."

The *Moses* result may appear somewhat harsh, particularly in a case like this involving a medium-sized no-load fund where there were stronger business reasons against seeking recapture, at least for the period when reciprocals or give-ups to brokers in return for sales efforts were in vogue. However, we think the considerations against allowing defendants to attempt to prove that, after independent investigation by the disinterested directors, the board might reasonably have concluded not to recapture, or at least not to go all out for recapture, see Part IV, *supra*, similarly foreclose defendants with respect to damages, as long as damages are limited to the business as actually conducted, namely, to tender fees and to those transactions carried out on the PBW and Pacific Coast Exchanges. On the other hand, if plaintiffs desire to pursue the path, noted in fn. 25 to *Moses*, of urging that the

> Adviser should have routed more of Fund's business to the PBW and Pacific Coast Exchanges, and of endeavoring to estimate what would have been recapturable if it had, compare *Weiss* v. *Chalker, supra,* 55 F.R.D. [168] at 171 [(S.D.N.Y.1972)], defendants should be allowed to develop the practical arguments against doing this, although not to relitigate the issues of possibility and legality of recapture. If this should seem a departure from strict logic, it would not be the first time this has occurred in the law of damages (Footnotes omitted.)

Appellants' first argument with respect to damages is in substance an objection to our precluding, to the extent that we did, the presentation of evidence that recapture would have been adverse rather than beneficial to the Fund. They argue that such preclusion eliminated an essential link in proof of damages, namely, causation, since thoroughly informed independent directors could well have decided against recapture, as the directors of the Chemical Fund did, see *Tannenbaum* v. *Zeller, supra,* 552 F.2d 402. We reject the argument. The record revealed an utterly perfunctory presentation of the question of recapture to the independent directors, 533 F.2d at 746-50, whom Congress had mandated in order "to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs", S.Rep.No.91-184, 91st Cong., 1st Sess. 32 (1969), *reprinted in* [1970] U.S.Cong. & Admin.News 4897, 4927 (1970). This "caused" the Fund to forgo recapture, by removing the switch which, after proper disclosure, the independent directors might have set so as to send the Fund down the recapture road. To require a plaintiff to prove that the independent directors would not have opted for recapture no matter how full the disclosure would make the disclosure requirement a dead letter. A pertinent analogy exists in the law with respect to misrepresentation. There it is settled that in order to show causation a plaintiff need not prove that the recipient "would not have acted or refrained from acting as he did

unless he had relied on the misrepresentation." Restatement (Second) of Torts § 546, Comment b (1977). In this case failure of the defendants to make an adequate disclosure to independent directors is the legal equivalent of misrepresentation. Justice Blackmun's observation in *Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 154, 92 S.Ct. 1456, 1472, 31 L.Ed.2d 741 (1972), that "This obligation to disclose and this withholding of a material fact establish the requisite causation in fact", is fully applicable here. We reiterate our agreement with *Moses* v. *Burgin*, *supra*, 445 F.2d at 385, that "Management having wrongfully prevented the matter from coming up, must bear the full consequences."

Apart from the argument just rejected, appellants' criticisms with respect to damages relate solely to the allowances for underwriting discounts and commissions, and commissions that could have been earned on the PBW Exchange as "reciprocals" for Fund business given to brokers on the NYSE and AMEX. Neither of these was mentioned in the quoted portion of our opinion relating to damages. Thus it became necessary for the Magistrate and the district judge to categorize these claims as either business actually conducted or business rerouted to a regional exchange since *Fogel I* permitted a business desirability defense only as to the latter.

Plaintiffs' claim with respect to the recapture of underwriting discounts was that these could readily have been accomplished by establishing a brokerage affiliate with NASD membership and causing the affiliate to become a member of the underwriting or selling group which marketed the stocks in which the Fund invested. As a member the affiliate would have been entitled to commissions on the securities purchased by the Fund without having to do any actual marketing work, and could lawfully have paid such fees in the form of dividends to the Adviser, which would then have been obliged to credit them to the Fund. The Magistrate considered this to be an issue where full inquiry as to

desirability, possibility and legality was required. He found possibility by combining our conclusion in *Fogel I* that NASD membership was available to an affiliate of the Adviser, 533 F.2d at 752, and a finding that the Adviser had sufficient leverage to force its way into the selling group. He found legality on the basis that although the rules of the NASD prohibited a broker acting on behalf of a mutual fund to transmit commissions to the fund either directly or by way of crediting an advisory fee, nothing prevented an adviser-owned affiliate from declaring dividends representing underwriting profits, with the Adviser then crediting such dividends to the Fund's benefit. On the basis of these findings he concluded that at least 25% of the underwriting discounts, commissions and allowances on underwritten securities purchased by the Fund were recapturable. Apparently no evidence was offered that having such an affiliate designated as a member of the selling group would have been an undesirable business practice or that the Fund lacked the necessary leverage. Indeed there was evidence that the Fund had caused the lead underwriter to designate as members brokers who had assisted in the sale of Fund shares. All these conclusions were in line with those that had been reached by Judge Frankel in the case of another fund, *Papilsky* v. *Berndt*, [1976-1977] Fed.Sec.L.Rep. ¶95,627, at 90,128-29 (S.D.N.Y. June 24, 1976).

The district court considered the subject and in a well reasoned discussion, 493 F.Supp. at 1197-99, agreed with the Magistrate except for thinking that, in light of the expenses and risks of underwriting, an underwriting syndicate might resist according a 25% share to an affiliate bearing none of these, and thus adopted a 20% share as more conservative.

Two specific criticisms are made by appellants with respect to the district judge's conclusion on this subject. First, they claim that "This category of damages should . . . have been open to a full defense." (Reply Brief, p. 19) The short answer is that the Magistrate so held and there is no indication that the district judge disagreed. Second, they assert that "the way damages were computed for this category was wholly conjectural." *Id.* at

19 n.25. However, there was no doubt that some underwriting discounts and commissions could be recaptured, as conceded by defendant Greene and as found in *Papilsky* v. *Berndt*, and the district judge's 20% figure was modest enough.

A more controversial subject is plaintiffs' claim for reciprocal brokerage. Plaintiffs' expert, Sherman O. Jones, who had headed a brokerage affiliate of Waddell & Reed, Inc., adviser to United Fund, which had been one of the leaders in recapture, described this practice as follows: Because of the attractiveness of mutual fund business, typically consisting of large amounts of securities, under the then fixed commission rate structure, brokers receiving orders from advisers for execution on the NYSE or AMEX were willing to pay a reward by sharing with affiliates of advisers who were members of regional stock exchanges a portion of the commissions on business which the brokers conducted on such exchanges. In *Fogel I*, we referred to the portion of the SEC's PPI report dealing with that subject, 533 F.2d at 736, and also found on our own that at least until the abolition of reciprocals on July 15, 1973, an affiliate of the Adviser as a member of the PBW exchange could "obtain PBW Exchange business from NYSE brokers in return for execution on that exchange", 533 F.2d at 752. Plaintiffs' expert testified that only 60% of the commissions payable to brokers for business transacted on the NYSE and AMEX would have provided leverage for reciprocal dealing since the other 40% would be needed as a reward for research or other services. The established practice of reciprocation at the rate of $100 in shared commissions on the PBW for every $200 in commissions for fund transactions executed on NYSE and AMEX would result in recovery of 30% of the total commissions (60% subject to recapture times 50% recapture rate yields 30%).

The Magistrate considered this to be an area where the desirability defense was entertainable. He found that:

> Demands to share commissions entailed considerable risks due to the delicately balanced financial and psychological factors inherent in the bargaining process of the securities market, and the possibilities for recapture appear to have been far fewer than plaintiffs contend.

The principal basis stated for this was that:

> During the period at issue in this suit only about one in eight or ten mutual funds was recapturing although the potential for recapture was generally known (Tr. 245), and although the PBW was actively soliciting members and using the possibility of recapture as a selling point.

He thought that:

> This evidence raises an inference that plaintiffs' arguments in regard to the Fund's potential for recapture are overly optimistic.

He also criticized plaintiffs' witness for not analyzing "the Fund's trading figures in detail to arrive at a reasonably precise proportion of recapturable trade commissions", concluded that it was "plaintiffs' burden to elicit from their witnesses the detailed basis of the analysis, if there was any", and held they had failed to sustain this.

The district judge took a different view, 493 F.Supp. at 1199-203. He disagreed with the Magistrate's assessment that plaintiffs' estimates of the possibilities of recapture through reciprocals were overly optimistic. He thought that this conflicted with our opinion in *Fogel I* and with Judge Frankel's opinion in *Papilsky* v. *Berndt* and with the testimony that in addition to the advisers mentioned in the PPI Report and in our opinion who had pursued this method of recapture, the same device had been employed by Dreyfus Corp., adviser for one of the largest aggregations of mutual funds. He did not think detailed analysis of the Fund's trading figures was essential or even "meaningful". He cited testimony of plaintiffs' witness that beginning in 1969 Waddell & Reed's affiliate had increased the rate of reciprocal business from 50% to 75% and that over the period from 1966 to 1973 had recaptured 42% of commissions paid on all exchanges. However,

in the interest of conservatism and because of possibly distinguishing factors, he reduced the percentage of NYSE and AMEX commissions that would be recaptured through reciprocal brokerage from Jones' 30% figure to 20%. On the basis of Jones' 2-1 formula, this was equivalent to finding that only 40% rather than 60% of the NYSE and AMEX commissions were subject to reciprocity.

We think the Magistrate was mistaken in the legal test he applied to reciprocals. The second category outlined in the quoted passage of our opinion in *Fogel I* was addressed to possible claims by plaintiffs "that the Adviser should have routed more of *Fund's* business to the PBW and Pacific Coast Exchanges, and of endeavoring to estimate what would have been recapturable if it had". 533 F.2d at 756 (emphasis added). What we had in mind was that the Adviser might not have been able to obtain the best possible execution if large amounts of the fund's business had been rerouted to these regional exchanges and that the defendants should be allowed to establish this if they could. The plaintiffs' claim here at issue did not involve any change in the Fund's allocation of its own business among the various exchanges. The computations were based on the volume of transactions actually conducted for the Fund by brokers on the NYSE and AMEX and unrelated business done by those brokers on the PBW Exchange. Defendants' evidence was not that recapture of reciprocals was impracticable but that it was undesirable for various reasons, primarily the obvious one that the brokers executing trades for the Fund on NYSE and AMEX would like to retain full commissions on all their business on the PBW Exchange and thus would give some preference on a variety of matters to funds that allowed them to do this. This was precisely the kind of information that could and should have been placed before the disinterested directors so that they could weigh the intangible advantages of receiving more enthusiasm from brokers both in the execution of orders and in pushing sales and furnishing research against the ascertainable amounts that were obtainable by insisting on reciprocity. If the independent directors had received opinions such as those

adduced from defendants' experts at the damages trial and had then decided not to seek reciprocals, we would have a different case, see *Tannenbaum* v. *Zeller, supra,* 552 F.2d at 416-29. Since the Magistrate applied a wrong legal standard, his findings are not, as urged by appellants, protected by the "unless clearly erroneous" provision of F.R.Civ.P. 53(e)(2). See, *e.g., United Artists Television, Inc.* v. *Fortnightly Corp.,* 377 F.2d 872, 874 n.2 (2 Cir. 1967) (Rule 52(a)), *rev'd on other grounds,* 392 U.S. 390, 88 S.Ct. 2054, 20 L.Ed.2d 1176 (1968); *NLRB* v. *Alterman Transport Lines, Inc.,* 587 F.2d 212, 220 (5 Cir. 1979); 5A Moore's Federal Practice ¶¶ 52.03[2], 53.12[5] (2d ed. 1980) (Rules 52(a), 53(e)(2)).[14] We therefore sustain the district court's computation of damages.

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14. Even if the "unless clearly erroneous" test were applicable, there would be sufficient ground for the district judge to have upset the Magistrate's conclusions. The Magistrate never found that demanding reciprocity for 60%, much less 40%, of the Fund's NYSE and AMEX business would have been disadvantageous. His conclusions were based rather on his belief that the "possibilities for recapture appear to have been far fewer than plaintiffs contend" and on the failure of plaintiffs' expert to make a detailed analysis of all the Fund's portfolio transactions over the six year period. The principal ground for his belief that the possibilities of recapture were fewer than plaintiffs contend was his inference from the fact that a relatively small percentage of mutual funds engaged in recapture through insisting on reciprocity. This fact had little meaning in the absence of evidence that the failure of most funds to follow the reciprocal route was due to a considered decision that on balance this would be disadvantageous to the fund rather than what Judge Wyatt characterized as "the selfish and conflicting interests of their advisers which, as in the case of the Adviser here, followed age-old patterns of human nature and preferred to use the 'fat' in the NYSE and AMEX commissions for their own benefit rather than for the benefit of the funds." 493 F.Supp. at 1201. The criticism for failure to make a detailed analysis of the Fund's transactions ignores the large deductions, 40% in the case of the plaintiff's expert and 60% in the case of the district judge, for transactions where it would not have been feasible to demand reciprocity. We have found nothing to indicate that these deductions would not have been ample to cover block trades and crosses—the two types of transactions as to which defendants' witnesses most articulately explained the undesirability of requiring reciprocity. In fact, plaintiffs' expert indicated that due to the smaller size of the Fund's trades as compared to those of United Funds, on which his experience was based, it would have been easier for the Fund to negotiate reciprocal brokerage. We agree with the district judge that in the absence of contention and proof by defendants that there was something

III.
CURRIER

Our opinion in *Fogel I* recognized special problems with respect to the defendant John Currier. When elected as a director of the Fund in 1962 as an outside business man, he was an "unaffiliated" director, see 533 F.2d at 746 n.15. He remained so after his acquisition of a 2% stock interest in the Adviser in 1964. However, he became an "interested" director as a result of § 5 of the Investment Company Amendments Act of 1970, which amended § 10(a) to substitute the word "interested" for "unaffiliated" in the requirement for a minimum of 40% of independent directors and defined "interested person", §§ 2(19)(A)(iii), (B)(iii), so that Currier's stock interest in the Adviser, which had been reduced to 1.2% by that time, brought him within that term. While this made him ineligible to meet the 40% requirement, nothing in the Act explicitly imposes any special duties on directors who are "interested" but not a part of management.

All the defendants in *Fogel I* were represented by the same counsel, Clendon H. Lee. No argument was made to us that any difference existed as regards the liability of the Adviser, of the three management directors—Chestnutt, Sabel and Greene, and of Currier. The defense was that there was no liability on the part of anyone since *Moses* v. *Burgin, supra,* had been wrongfully decided or in any event was inapplicable to a no-load fund which sold its own shares without the intervention of an affiliated underwriter. However, we did take note of the problem with respect to Currier on our own initiative, saying, 533 F.2d at 750:

> We therefore conclude that liability exists with respect to the Adviser and to defendants Chestnutt, Sabel and Greene. Under the principle laid down in *Moses, supra,*

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unusual about the Fund's transactions, it would impose too great a burden to require plaintiffs' expert to examine hundreds of transactions and come to a judgment whether it would have been possible to obtain reciprocity with respect to each Jones' extensive experience in doing exactly what plaintiffs asserted entitled him to express an informed judgment without getting into such detail.

> 445 F.2d at 384, we would see no basis for imposing liability on directors who were not interested. In this respect defendant Currier is a special case; although he could be counted as unaffiliated until December 14, 1970, because of his small stock ownership in the Adviser he was in fact not disinterested. We therefore include him with the defendants held to be liable. While we do not rule on the apportionment of liability, equity would suggest the imposition of primary responsibility on the Adviser, which profited from the failure to recapture.

Defendants' petition for reconsideration was addressed solely to the broad issue we had decided; nothing was said as to Currier's special position.

Although our opinion ought surely to have alerted Lee and Currier, if they had not already been so, of Currier's need for separate counsel, Lee continued to act for all the defendants. Currier was not called as a witness at the hearings before Magistrate Schreiber. In the course of oral argument held after the submission of evidence, the Magistrate said to Lee:

> I do want you to take up the issue that the Chief Judge had noted on page 750 as to the apportionment of the liability as to primary responsibility. If this Court is going to make a ruling on damages, it seems to me it falls upon the Court to accept the responsibility of apportioning the damages or are you of the contrary opinion?

Lee declined to take advantage of the opportunity, saying that "the Court is required to dismiss the case against the individuals." The Magistrate concluded in his report:

> The Second Circuit suggested that primary liability should be imposed on the Advisor, and that defendant Currier's liability was of a lesser degree than that of the other individual defendants, but it did not rule on the apportionment of liability. Because all defendants were

> represented by the same attorney during these proceedings, and no proof of individual responsibility was introduced, a finding of degrees of fault of the individual defendants is not feasible.

While by this time it had become crystal clear that Currier needed separate counsel, nothing was done about it,[15] and it does not appear that any exception was taken to this portion of the Magistrate's Report. In any event the district judge concluded, 493 F. Supp. at 1204:

> The Master correctly found (Report, p. 4) that no evidence would justify a distinction between the defendants as to the extent of their liability. The judgment will be against all of the defendants in the same amount.

Judgment was entered on June 27, 1980, finding all defendants jointly and severally liable.[16] At this time Currier did what should have been done long ago, namely, engage separate counsel. They promptly filed a motion on July 9, 1980, for an order pursuant to F.R.Civ.P. 59 and 52 for a new trial or to alter and amend the judgment "so as to diminish this [Currier's] liability and subordinate it to that of the other defendants." The district court denied the motion without opinion.

In their briefs in this court, Currier's counsel argue that our opinion in *Fogel I* was in error in holding Currier to be liable for a breach of fiduciary duty. They contend, *inter alia*, that he was never part of the Adviser's management and that rather than

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15. Currier averred in his affidavit in support of a motion for a new trial referred to below that after the Magistrate's report was issued, Lee advised him that the Magistrate had not recommended any assessment of damages against the individual defendants and that Currier "was, in effect, out of the case." We are, of course, unable to pass on the truth of this.

16. Currier exaggerates the extent to which our holding in *Fogel I* was based on the 1970 change in the ICA. As the quoted passage shows, our statement was predicated on the point that because of his stock holding in the Adviser, Currier "was in fact not disinterested"—not on the basis that the 1970 amendments resulted in his being classified as "interested" rather than unaffiliated.

owing a duty of disclosure to nonmanagement directors as representatives of the Fund's shareholders, he was owed one; that we gave undue weight to the fact that by virtue of the Investment Company Amendments Act of 1970 he became an "interested" director; and that even if we were right in doing so, any liability because of this change should be limited to damages accruing after December 14, 1970. Citing *Johnson* v. *Cadillac Motor Car Co.*, 261 F. 878, 886 (2 Cir. 1919), they urge that, for these and other reasons, we should reconsider our holding with respect to Currier in *Fogel I* despite the doctrine of the law of the case. Alternatively they ask us to cause the district court to do what we had expected, namely, to make an equitable apportionment of liability, either by modifying its judgment with respect to Currier or by reversing its denial of Currier's post-trial motion.

Without passing on the soundness of Currier's arguments, we at least agree that if these had been presented to us six years ago, there would have had to be much more extensive consideration whether Currier was liable at all than the short paragraph we have quoted. On the other hand, it would be a dangerous precedent to depart from the law of the case simply because new counsel have come up with arguments that could equally well have been presented when the case was first here. Currier does not fit the picture of the guileless innocent that counsel seek to draw. He is a graduate of Penn State University and the Harvard Business School and has had a successful and extensive business career. Our opinion in *Fogel I*, knowledge of which he does not deny, should have alerted him to the need of having his "special case" presented by petition for reconsideration or, failing that, by offering proof before the Magistrate. Instead he continued to allow himself to be represented by Lee, whom, as we learn from Currier's affidavit supporting his post-trial motion, was doing this without additional compensation. Beyond this, in light of the assurances given by plaintiffs' counsel, see note 3, and the absence of any suggestion that the other defendants are unable to pay the judgment, there seems to be little reason to fear that Currier will suffer actual financial loss.

However, we recognize that the very existence of the judgment constitutes a hardship. Although we fully understand the reluctance of the magistrate and the district judge to take action on our suggestion with respect to apportionment in light of Lee's stubborn refusal to address the issue even after the Magistrate's request, the record contained sufficient evidence for doing this and we see no reason why we should not do it ourselves rather than prolong this case by a second remand.[17] We continue to believe that primary responsibility should rest on the Adviser which profited, or at least was intended to profit, from the failure to recapture, 533 F.2d at 750, see I Palmer, The Law of Restitution §§ 2.11, 2.12 at 158 (1978), not indeed in the actual receipt of cash but in increased advisory fees due to the sale of shares by

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17. None of the parties has argued that imposition of primary responsibility on the Adviser and apportionment of any liability undischarged by it among the individual defendants would go beyond our authority. The recent decisions of the Supreme Court in *Northwest Airlines, Inc.* v. *Transport Workers*, 451 U.S. 77, 101 S.Ct 1571, 67 L.Ed.2d 750 (1981), and *Texas Industries, Inc.* v. *Radcliff Materials, Inc.*,—U.S.—, 101 S.Ct. 2061, 68 L.Ed.2d 500 (1981), against the imposition of contribution under the Equal Pay Act and Title VII of the Civil Rights Act of 1964, and § 4 of the Clayton Act rested on the basis that the statutes there under consideration expressly created the private damage actions and failed to provide for contribution, although § 11(f) of the Securities Act of 1933 and § 18(b) of the Securities Exchange Act demonstrated that Congress knew how to do this when it wished. The Court left open the question whether federal courts could properly provide for contribution when an implied right of action was found to exist under the securities laws, *Northwest Airlines*, 101 S.Ct. at 1580 n.24; *Texas Industries*, 101 S.Ct. at 2066 n.11. It noted that some courts have implied such a right to contribution, see, *e.g.*, *Heizer Corp.* v. *Ross*, 601 F.2d 330, 331-34 (7 Cir. 1979) (and cases cited at 332-33); *Globus, Inc. v. Law Research Service, Inc.*, 318 F.Supp. 955 (S.D.N.Y. 1970) (Frankel, J.), *aff'd per curiam*, 442 F.2d 1346 (2 Cir.), *cert. denied*, 404 U.S. 941, 92 S.Ct 286, 30 L.Ed.2d 254 (1971). Here Currier assumes that he would be entitled to contribution if the judgment were left untouched (Reply Brief at 6n**) but argues that this remedy is insufficient. The present action is in essence a suit in equity against defendants for violation of their fiduciary duties, and equity courts traditionally have had wide discretion to mold their decrees in the interest of justice, *Hecht Co.* v. Bowles, 321 U.S. 321, 329-30, 64 S.Ct. 587, 591-92, 88 L.Ed. 754 (1944). Even in an action at law for damages under Rule 10b-5, we have said that a court may limit the liability of a class of defendants. *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 242 (2d Cir. 1974).

brokers who favored the Fund because of its no-recapture policy and by avoiding the expense of conducting research done by the brokers. Of any balance not recoverable from the Adviser, Currier should be liable only in the ratio of his stock ownership in the Adviser in any year to the total stock ownership of all the individual defendants. For reasons indicated in footnote 16, we draw no distinction between damages before and after December 14, 1970. These same principles shall apply to any further judgment awarding plaintiffs expenses and attorneys' fees.

The judgment is affirmed as so modified. Plaintiffs may recover their costs against defendants other than Currier. No costs as between plaintiffs and Currier.

United States District Court

SOUTHERN DISTRICT OF NEW YORK

68 Civ. 2855 (IBW)

Judgment

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

—against—

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, AMERICAN INVESTORS FUND, INC., CHESTNUTT CORP.,

Defendants.

Following a trial before the Court, Inzer B. Wyatt, District Judge, presiding, judgment was entered dismissing this action. The United States Court of Appeals for the Second Circuit reversed this judgment and remanded the cause to this Court for the determination of damages. This Court referred the issue of damages to Honorable Sol Schreiber, United States Magistrate, to hear and report to the Court. The Magistrate conducted hearings and filed his report.

Plaintiff and defendants moved to modify the report. The Magistrate's report and the briefs of the parties having been read, argument having been heard, and a decision having been filed on June 19, 1980, it is

Ordered and Adjudged:

1. Defendant American Investors Fund, Inc., shall recover in this action brought on its behalf by plaintiffs Rosalind Fogel and Gerald Fogel from the defendants Chestnutt Corporation, George A. Chestnutt, Jr., Stanley L. Sabel, Warren K. Greene

and John Currier, jointly and severally, the sum of $3,919,220.00 (Three Million, Nine Hundred Nineteen Thousand, Two Hundred Twenty Dollars), consisting of the principal sum of $2,370,357, together with interest as follows:

Year	Rate of Interest	Principal Amount	Amount of Interest
1968	6.00%	$ 306,196	$ 18,371
1969	7.25%	844,160	61,201
1970	7.50%	1,403,490	105,261
1971	7.50%	1,828,105	137,107
1972	7.50%	2,165,652	162,423
1973	6.00%	2,337,106	140,226
1974	6.00%	2,367,637	142,058
1975	6.00%	2,370,357	142,221
1976	6.00%	2,370,357	142,221
1977	6.00%	2,370,357	142,221
1978	6.00%	2,370,357	142,221
1979	6.00%	2,370,357	142,221
1/1/80-6/30/80	6.00%	2,370,357	71,111
			$1,548,863

Such recovery, and any parts thereof, shall be paid to defendant American Investors Fund, Inc.

2. Plaintiffs Rosalind Fogel and Gerald Fogel shall recover of defendant American Investors Fund, Inc. the costs of this action.

3. The Court reserves jurisdiction to award to plaintiffs and their counsel the expenses of this action, including reasonable legal fees.

Dated at New York, New York
this 27th day of June, 1980

Clerk of the Court

The form of the above judgment is hereby approved.

INZER B. WYATT
Inzer B. Wyatt
United States District Judge

UNITED STATES DISTRICT COURT,
S. D. New York.
June 19, 1980.

ROSALIND FOGEL AND GERALD FOGEL,

Plaintiffs,

v.

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, AMERICAN INVESTORS FUND, INC., CHESTNUTT CORP.,

Defendants.

No. 68 Civ. 2855.

WYATT, District Judge:

This is the decision on the issue of damages to be awarded against defendants Chestnutt Corporation, Chestnutt, Jr., Sabel, Greene, and Currier in favor of American Investors Fund, Inc. (the Fund) for whose benefit this derivative action was brought by the two Fund stockholders who are plaintiffs.

The action was tried to this Court without jury on the issue of liability alone. There was a demand for a jury trial by plaintiffs but, assuming that a jury trial would have been required, all parties waived any right to a jury trial.

On October 29, 1974, this Court filed an opinion directing judgment for defendants, dismissing the action on the merits. 383 F.Supp. 914.

On December 30, 1975, the judgment of dismissal was reversed by the Court of Appeals. 533 F.2d 731 (2nd Cir.) Judge Friendly wrote a careful opinion for a unanimous Court. The defendants named first above were found liable to the Fund, guidance was given on the issue of damages, and the action was remanded for determination of damages. Certiorari was denied on October 4, 1976. 429 U.S. 824, 97 S.Ct. 77, 50 L.Ed.2d 86.

On October 27, 1976, an order of this Court was filed which referred the determination of damages to Honorable Sol Schreiber, then a United States Magistrate, who was asked "to file his report thereon with findings of fact and conclusions of law". Fed.R.Civ.P.53.

Between January 18, 1977, and June 2, 1977, Magistrate Schreiber heard testimonial evidence, received other evidence, and listened to arguments.

On November 6, 1978, the report of the Master, dated October 31, 1978, was filed. That report, after explanations, findings and conclusions, determined that the damages were $349,013.04 plus interest.

On November 13, 1978, counsel for plaintiffs filed three documents:

a. "Objections to the Magistrate's Report";

b. "Memorandum in Support of Plaintiff's objections to the Magistrate's Report"; and

c. "Notice of Motion" for an order modifying the Master's Report and entering judgment accordingly.

On November 16, 1978, counsel for defendants served but did not file two documents:

a. "Defendants' Objections to the Magistrate's Report"; and

b. "Memorandum in Support of Defendants' Objections to the Magistrate's Report."

On November 20, 1978, counsel for defendants filed a document:

"Notice of Cross Motion and Suggestion".

The cross motion was for an extension of time for the parties "to complete their presentation of facts and law to the Court."

On November 22, 1978, counsel for plaintiffs filed a document:

"Plaintiffs' Memorandum in Connection With the Magistrate's Report and in Opposition to Defendants' Cross Motion".

On February 6, 1979, there was a conference between Court and counsel; the conference was stenographically reported. Among other things, a time was fixed within which defendants could complete their papers dealing with the Master's Report. Oral argument on that subject was set for March 2.

On February 20, 1979, counsel for defendants filed two documents:

a. "Notice of Motion" for an order modifying the Master's Report and directing entry of a judgment dismissing the Supplemental Complaint"; and

b. "Memorandum in Support of Motion to Modify Magistrate's Report and to Dismiss Complaint."

On March 2, 1979, counsel were heard in oral argument.

1.

Plaintiffs object to one portion of the Master's Report, that contained in Section IIIB of the Report where the Master finds that damages should not be awarded for failure to recapture "reciprocal brokerage and crosses".

Defendants object to each and every thing contained in the Master's Report, assert that no damages have been proved, and that the action should be dismissed on the merits. Defendants attempt to support their position, not by discussion of the evidence as to damages but by reargument of the matters decided by the Court of Appeals.

It is my duty to accept the opinion and decision of the Court of Appeals and, on the basis of the record made before the Master and with the help of his Report, to direct the entry of a correct judgment for money damages.

American Investors Fund, Inc. will be referred to herein as "the Fund". Chestnutt Corporation will be referred to herein as "the Adviser." The New York Stock Exchange will be referred to

herein as "NYSE". American Stock Exchange will be referred to herein as "Amex". National Association of Securities Dealers, Inc. will be referred to herein as "NASD" (see 15 U.S.C. § 78*o*-3).

2.

The motion or suggestion or idea of the defendants that the action should be at this stage dismissed on the merits is rejected as without merit and is in all respects denied.

3.

This Court and the Court of Appeals were in agreement that the Adviser had a duty to recapture all excess brokerage and give-ups and all tender offer fees. This Court believed that no such recapture was possible. The Court of Appeals disagreed, holding that the Adviser or a subsidiary of the Adviser (often called an "affiliate") could and should have become a member of NASD. (For convenience, the term "Adviser" will often include a subsidiary or affiliate of the Adviser.) The Court of Appeals also held that the Adviser could and should have become a member of PBW Exchange. Had such memberships been secured, the Court of Appeals pointed to four areas in which recapture for the benefit of the Fund would have been possible:

A. As a member of NASD, the Adviser would have been entitled to give-ups of up to 40% of commissions on transactions executed on the PBW Exchange (533 F.2d at 750; reference was also made to a similar entitlement on Pacific Coast Exchange transactions, but plaintiffs do not here press any claim for damages in respect of the Pacific Coast Exchange);

B. As a member of PBW Exchange, the Adviser "could have received a substantial portion of commissions as an introducing broker, perhaps as much as 80%" (533 F.2d at 752);

C. As a member of PBW Exchange, the Adviser could also have obtained "PBW Exchange business from NYSE brokers in

return for placing orders with them for execution on that exchange" (533 F.2d at 762; this would be a form of reciprocal arrangement); and

D. As a member of NASD, the Adviser would have been eligible to receive tender offer fees (533 F.2d 750; when a tender offer is made, the maker usually advertises an agreement to pay a fee to any NASD member named by a stockholder who tenders, the fee being a specified amount per share tendered and accepted).

It will be noted that recapture in areas A and B above could not both be obtained because this would be duplicative. If the Adviser were a member of the PBW Exchange and of NASD, recapture as a PBW Exchange member (area B) would be more advantageous for the Fund because the permitted percentage recapture would be higher.

The Court of Appeals, in giving guidance as to damages, ruled as to the period of time involved. The period of liability begins on March 1, 1967 (533 F.2d at 755). The period of liability for failure to recapture give-ups through membership in NASD ends on December 6, 1968, when give-ups were abolished by the stock exchanges (533 F.2d at 740, 755). The period of liability for failure to recapture through membership in the PBW Exchange ends on March 29, 1973, the effective date of Rule 19b-2 which made it essential for stock exchange members to conduct a "public business" of brokerage and thus abolished institutional recapture memberships (in this Court's earlier opinion the effective date of Rule 19b-2 was stated to be March 15, 1973 (383 F.Supp. 914 at 918 [D.C.]); this was an error; the Rule as promulgated in the Federal Register (38 Fed.Reg. 3928 (1973)) was stated to be effective March 15, 1973, but because of litigation this date was later postponed by SEC order to March 29, 1973). The period of liability for failure to recapture tender offer fees ends on the day of judgment unless this Court finds reason in the record to rule otherwise.

The Master found damages of $144,143.81 in area B; no damages in area C; and damages of $43,885.50 in area D.

In addition, the Master found damages of $184,730.30 in the area of "Underwriting Discounts, Commissions and Allowances".

From the total in damages of $372,759.61 thus found, the Master found that $34,217.07 should be deducted as the expense which would have been incurred by membership in NASD and in the PBW Exchange. The net damages as found by the Master were thus $338,542.54. As a result of arithmetical errors (in one instance, perhaps a typographical error) by the Master (not noticed by the parties and so not brought to the attention of the Court), the Report (p. 17) expressed the figure as $349,013.04.

The errors appear in Table 7 on page 17 of the Report. The figure shown in that Table for 1968 is "47,939.81". This figure is supposed to be the sum of $10,546.56 (Table 2) plus $1,200.00 (Table 3) plus $41,227.75 (Table 5) minus $5,505.00 (Table 6). The resulting figure should be $47,469.31. The figure shown in Table 7 for 1972 is "29,005.75". This figure is supposed to be the sum of $16,424.30 (Table 2) plus $8,086.45 (Table 5) minus $5,505.00 (Table 6). The resulting figure should be $19,005.75.

The total of Table 7, representing the total damages found by the Master, should be $338,542.54.

4.

The Master first dealt with damages from failure of the Adviser to obtain membership in the PBW Exchange for itself or for an affiliate and to recapture "a substantial portion of commissions as an introducing broker" (533 F.2d at 752).

The Master found that between March 1, 1967 and March 29, 1973—the relevant period according to the Court of Appeals (533 F.2d at 755)—the Fund paid $180,179.77 in commissions on transactions effected for the Fund on the PBW exchange and that 80%, or $144,143.81, could have been recaptured by membership in the PBW Exchange. Had the Adviser been a PBW member, the executing broker on that Exchange could have shared commissions with the Adviser as an "introducing broker" member, a sharing not permitted with non-members. The Master found that 80% would have been the share to the Adviser for the benefit of the Fund.

The Master took note of testimony for defendants that the executing broker would retain more than 20%, but did not accept it. The Master noted that there was conflicting testimony and referred to the statement in Judge Friendly's opinion that the recapture could be of "a substantial portion of commissions as an introducing broker, perhaps as much as 80% . . .". (533 F.2d at 752.) In the record before Judge Friendly there was testimony by the President of the PBW Exchange that an introducing broker would retain a percentage of the Commission and that "somewhere in the neighborhood of 80 per cent would be retained" (Stenographic Minutes of Trial p. 46). In *Papilsky v. Berndt*, CCH, Fed.Sec.L.Reptr. ¶ 95,627 (S.D.N.Y. 1976), Judge Frankel noted: "Mr. Elkins Wetherill, President of the PBW, testified that introducing brokers would negotiate to keep up to 80% of the commission".

The only discussion by defendants in this Court of this element of damages, so far as I can find, is this statement on page 13 of an undated, unfiled memorandum:

> "As to gross commissions charged the Fund on PBW over seven years (Table 1) of $180,179.77, only the amount of give-ups directed to be paid to non-executing brokers of about 30% thereof should be taken into account."

This comment seems to miss the point entirely. What the defendants and the executing brokers may have decided to give up to others is irrelevant. The only relevant inquiry is what percentage of total commissions paid by the Fund on PBW transactions could have been recaptured for the Fund had the Adviser been a PBW member.

The Master was justified in allowing as an element of damages $144,143.81, the amount which "would have been" available for recapture through membership in the PBW Exchange. This is approved.

5.

The opinion of the Court of Appeals states that had the Fund secured NASD membership "it would have been entitled . . . to

tender offer fees." (533 F.2d at 750). A footnote added this explanation: "The maker of a tender offer frequently agrees to pay a fee to any NASD member named by the tendering shareholder."

The Master found that the Fund had "paid tender offer fees" in the amount of $43,885.50 (Report, p. 8) and since these could have been recaptured (or captured) for the Fund, awarded this amount as damages. (The Master, as will be seen, is mistaken in saying that the *Fund* paid any tender offer fees.)

The evidence fully supports the finding of the Master. Exhibit 100 was prepared by defendants and includes the amount of "tender fees" as found by the Master; Exhibit 100 was offered by plaintiffs and received without objection by defendants on grounds of accuracy (SM 112; "SM" references herein are to pages of the stenographic minutes of the hearing before the Master). The terminology employed by the Master is somewhat inaccurate. Tender offer fees were not "paid" by the Fund; they were "paid" by the corporation making the offer to buy stock tendered; they were paid to any NASD member named by the tendering stockholder. The reason for the payment was that the offeror, the would-be purchaser of stock, was anxious to have as many shares tendered as possible. To encourage brokers to solicit tenders of stock, the offeror agreed to pay a stated amount per share to the NASD member broker-dealers named by the tendering stockholder. This was explained in Judge Friendly's opinion and in this record by the expert witness for plaintiffs (SM 109-112). The amounts shown as "tender fees" in Exhibit 100 are evidently the amounts which would have been payable in respect of tenders made by the Fund or amounts actually paid in respect of such tenders by the offerors to NASD members designated by the Fund as rewards (similar to the give-up rewards).

So far as I can find, the only comment for defendants on this topic to this Court, is this statement on page 13 of an undated, unfiled memorandum:

> "As to the item of 'tender offer fees' (Table 3), only the single item of $3000 in 1974 occurred after SEC Release No. 10,102 in the year 1973. Thus, in accordance with the mandate, this sum can be taken into account."

Apparently, this is an attempt to argue that only damages after the date of the cited SEC Release No. 10,102 (April 12, 1973) are recoverable. If this be the argument, it is without merit. The cited SEC Release No. 10,102 referred to the *withdrawal* of a proposal by the SEC (made in Release No. 990, published December 27, 1972) to eliminate the payment of tender fees to an NASD affiliate of a big investment fund. In oral argument, counsel for defendants asserted (SM 90-91) that the SEC "had taken the position—indeed, I think in December of 1972 it took the flat position in Release No. 9902 [should be "9920"], . . . that any attempted recapture of a tender offer was illegal and in violation of the Williams Act." This assertion is in error. The SEC took no such position, did not mention illegality, and did not mention the Williams Act. In Release No. 9920 the SEC merely *proposed* a change in a Rule, which change was *withdrawn* by Release No. 10,102.

Judge Friendly cited (533 F.2d at 752) Release No. 10,102 to show SEC recognition (a) that an affiliate of an investment fund could become a member of an NASD and (b) that there may be an obligation on such investment fund to recapture tender fees through an NASD affiliate. The citation has no slightest bearing on the time period during which the duty to recapture existed. That time period was elsewhere (533 F.2d at 755) fixed in the opinion at March 1, 1967 to the "day of judgment" subject to a discretion of this Court to consider a shorter period. The Master properly ended the period on the "day of judgment".

The Master's finding on this item is approved.

6.

Under the heading "Underwriting Discounts, Commissions and Allowances", the Master awarded damages in the sum of

$184,730.30 (Report, p. 13). The Master found that this sum could have been recaptured as underwriting discounts or commissions, had the Adviser secured membership in NASD.

A principle found in the opinion of the Court of Appeals is in substance that the Adviser was under a fiduciary duty to become a member of NASD, either itself or by a subsidiary, and to recapture for the Fund whatever could be recaptured by a member of NASD. The Court of Appeals referred specifically, as some of the recapture opportunities through NASD membership, to the following: give-ups on the PBW and Pacific Coast Exchanges, discounts of 25% on the Pacific Coast Exchanges, and tender offer fees (533 F.2d at 750). The Court of Appeals did not refer specifically to underwriting discounts, but certainly could not have meant to exclude these as an element of damages, if established.

Between the date of the Court of Appeals opinion (December 30, 1975) and the date of the Master's Report (October 31, 1978) there had been filed on June 24, 1976, the opinion of Judge Frankel deciding *Papilsky* v. *Berndt*, cited above. Judge Frankel, after an extensive discussion, decided (among other things) that "recapture of underwriting fees" by an NASD member who was adviser to a big investment fund "was available and legal".

Shares are sold on stock exchanges through commission brokers by shareholders who own the stock, which has been already issued; the issuing corporation has nothing to do with sales on stock exchanges. However, when a big corporation wishes to raise money for itself, by selling new shares to the public, either when it begins business or later, it usually sells the new shares to an investment banker who resells to the public at a public offering price. The purchaser investment banker is called the lead underwriter. The lead underwriter does not usually act alone; he forms an "underwriting syndicate" of a number of investment bankers who each agree to be responsible for a part of the underwriting obligation, that is, for the sale of a certain number of shares. Another group is organized, called the "selling group". These are the broker-dealers who make the actual retail sales of the

shares. A member of the underwriting syndicate may also be a member of the selling group; there may be many members of the selling group who are not members of the underwriting syndicate. The profit of the lead underwriter, of the members of the underwriting syndicate, and of the members of the selling group comes from the difference between the agreed price to the issuer and the public offering price, often called the "gross spread". The lead underwriter receives a management fee in an agreed amount per share; the members of the underwriting sysdicate receive an "underwriting discount" or underwriting fee in an agreed amount per share; and the members of the selling group receive a "commission" or selling fee in an agreed amount per share sold by them at retail. Only members of NASD are eligible to become members of the underwriting syndicate or of the selling group. For a general description of the public offering-underwriting process, see R. Jennings & H. Marsh, Securities Regulation pp. 19-28 (4th ed. 1977).

There is a similar type of underwriting when the seller of the shares is not the issuer corporation but a large holder of shares of that corporation, shares already issued. These sales are made, for example, by the estate of a very large shareholder or by any holder of a very large number of shares—so many that an underwritten public offering is more advantageous than an attempt to sell on the stock exchanges. These offerings are called "secondary distributions" or, in shortened form, "secondaries". The methods and terminology of the underwriting are the same for secondaries as for the new issues, already described.

Since investment funds purchase shares in large amounts, the lead underwriter and the other participants eagerly solicit their business. Just as in the case of brokerage commissions, they were willing to give to an investment fund a part of their gross spread, underwriting discounts, commissions or fees—using the terminology already described—in return for the large volume purchase order of the fund. The method by which this was done, as found by Judge Frankel in *Papilsky* v. *Berndt*, above cited, was for the lead underwriter to agree with a fund that as a purchaser it "could

designate members of the underwriting or selling group to participate in the sales commissions. The underwriters would even include additional NASD members in the underwriting or selling group at the fund's request in order to permit them to receive commissions". In *Papilsky* v. *Berndt*, Judge Frankel found the defendants liable for the failure to recapture underwriting discounts and commissions by designating the fund adviser, an NASD member, as a member of the underwriting syndicates and selling groups.

In the case at bar, had the Adviser been so designated with the agreement of the syndicate or group, or both, the Adviser could have shared in the $738,921 "underwriting discounts" shown on Exhibit 100, just as in the case of a brokerage commission. It is not possible to learn from the evidence how much of the $738,921 figure was paid out by the underwriting syndicates to firms designated by the Adviser as a reward for assisting in the sale of Fund shares.

The Master, correctly in my view, adopted the same theory as Judge Frankel in awarding damages in this area.

The defendants in the case at bar knew of the recapture possibilities in this area, but as in the case of give-ups in general, preferred to use these advantages to reward broker-dealers who conferred benefits on the Adviser rather than to secure some benefit for the stockholders of the Fund. Defendant Greene testified that the Fund orders were "larger than normal" and "a larger transaction" (SM 1096) and that the Adviser telephoned the lead underwriter and designated "other underwriting firms in the group"; these were "very definitely" designated "on the basis of their assistance in the sale of fund shares" (SM 1096). The Master correctly reasoned that, had the Adviser secured NASD membership, it could have designated itself to share in the underwriting discount or commissions.

The evidence (principally Exhibit 100) shows that on the shares purchased by the Fund as new issues or secondaries from underwriting syndicate-selling groups, the purchase price paid by the Fund included $738,921 in "underwriting discounts". This

amount was calculated by the defendants by multiplying the number of shares bought by the Fund "by the amount of the underwriting discount per share" (letter from counsel for defendants, dated June 13, 1980). "Underwriting discount" as used in this letter is taken to be the same as "gross spread" earlier referred to—the difference between the price paid to the issuer and the public offering price.

The Master found that at least 25% of the $738,921 in "underwriting discounts" shown on Exhibit 100 could have been recaptured for the Fund had the Adviser become a member of NASD and had the Adviser used the large volume purchases of the Fund as leverage to come to an agreement with the lead underwriter to designate the Adviser as a member of the underwriting syndicate or selling group and to share in the discounts or commissions, or both. The damage award of the Master was $184,730.30.

While this finding of the Master can be justified on the evidence, it is more conservative to use a figure for recapture of 20%. This takes into account that on a public offering—whether new issue or secondary—there is considerable expense involved to the underwriting syndicate; there are counsel fees, advertising, printing of the prospectus, registration statement, etc. In addition, there is the risk that the issue may not sell and that the underwriters will have unsold shares on their hands with a falling market value. These factors might cause the underwriting syndicate to resist a 25% share to the Adviser. The 20% figure seems to me well within the bounds of reason and is certainly not high or too favorable to the plaintiffs. It will be used.

Applying the 20% to the $738,921 yields the amount of $147,784 which will be the damage award on this aspect of the claim of plaintiffs.

7.

The principal claim made by plaintiffs was for the amount which could have been recaptured had the Adviser or a subsidiary thereof secured membership the PBW Exchange and obtained reciprocal brokerage on that Exchange from members of NYSE

and Amex to whom Fund transactions on those exchanges were entrusted by the Adviser and which transactions produced substantial commissions to the NYSE and Amex brokers.

This method of recapture was already developed and in use by others during the relevant period. It was based on membership by the adviser in the PBW Exchange or some other regional exchange; it was not necessary for membership in the PBW Exchange, as it was for membership in NYSE and Amex, to be a broker-dealer offering services to the public. An investment adviser could be a member of the PBW Exchange. Brokerage commissions could be shared between members of the PBW Exchange as they could be shared between members of the NYSE and Amex; an adviser, however, as just noted, could not be a member of NYSE or Amex. It has already been seen, in connection with Fund transactions on the PBW Exchange, how up to 80% of the commissions could have been given to an adviser member of PBW as an "introducing broker". In return for the large volume of Fund transactions directed to brokers on NYSE and Amex, it could have been arranged with those brokers that *their* commissions on PBW Exchange be shared with Chestnutt Corp. (as Adviser to the Fund, and a PBW member) in an agreed percentage of commissions on Fund transactions executed by them on NYSE and Amex. A portion of NYSE and Amex commissions paid by the Fund could thus have been recaptured, could have been credited against the advisory fee charged by the Adviser, and could have inured to the benefit of the stockholders of the Fund.

As I read its opinion, the Court of Appeals approved this method of recapture and indicated clearly that it should figure in the calculation of damages.

The Court of Appeals noted (533 F.2d at 736):

> Meanwhile a few adviser-underwriters decided to recapture for their funds some of the spread between the fixed and unvarying commissions payable to executing brokers and the lesser amounts the latter were willing to accept on large orders.

In this connection, the Court of Appeals then quoted, with evident approval, from a Report of the SEC, Public Policy Implications of Investment Company Growth, House Report No. 2337, 89th Cong., 2d Sess., including the following (533 F.2d at 736; emphasis supplied):

> (a) Use of brokerage commissions to benefit the funds.
>
> (i) Reducing advisory fees.—As has been noted, subsidiaries of four adviser-underwriters that maintain their own retail sales forces—among them three of the largest, Investors Diversified Services, Inc., Waddell & Reed, Inc. and Channing Financial Corp., as well as the smaller Imperial Financial Services, Inc.—are now members of the Pacific Coast Stock Exchange. These subsidiaries execute orders for the funds on the Pacific Coast Stock Exchange. *More important, however, they obtain a considerable amount of nonfund business from broker-dealers who are dual members of the Pacific Coast Stock Exchange and other exchanges in return for fund brokerage business on other exchanges, primarily the NYSE.* All the net profits of IDS's subsidiary and about 40 to 50 percent of the net profits of Waddell & Reed's and of Imperial Financial Services' subsidiaries have been applied to reduce advisory fees payable by the funds in those complexes.
>
> Widespread emulation by institutional investors of the precedent set by these four complexes could have a marked effect on the economies of the securities industry. Within the framework of the existing commission rate structure it is a method whereby mutual fund shareholders can derive greater benefits than they have heretofore received from fund brokerage commissions.

The Court of Appeals later quoted, again with evident approval, from a letter of the General Counsel to the SEC, including the following (533 F.2d at 741; emphasis supplied):

As you suggest, the statements in letters from the Commission to stock exchanges in connection with their adoption of rules abolishing the customer-directed give-ups, that the Commission understood that these rules were not designed to terminate procedures whereby institutions may obtain returns of commissions merely reflected, in our view, that *the exchange rules with respect to customer-directed give-ups did not*, and were not intended to, *terminate the existing arrangements which a few mutual fund organizations have made for the indirect recapture of a portion of their commissions*. It is my understanding that this is not presently accomplished by means of customer-directed give-ups, which have been abolished, but in other ways, *primarily by reciprocal practices*. If these reciprocal practices are available to fund managements, it did not seem appropriate to foreclose their use to benefit the fund itself.

It should be understood, however, that if mutual fund management does acquire a seat on a regional stock exchange whose rules permit the recapture of commissions paid by the fund through the use of that seat, there may be circumstances under which such recapture could be required and that the management may not be free to simply retain for itself revenues derived from this source. This is particularly likely to be true where the affiliate on the exchange does not execute or clear transactions for the account of the fund, but *merely receives revenue from other brokers, which revenue is attributable to transactions executed for the account of the fund by such other brokers*. . . .

Finally, the Court of Appeals addressed itself directly to the item of damages now under discussion. The Court of Appeals said (533 F.2d at 752; emphasis supplied):

> However, the testimony of Elkins Wetherill, president of the PBW Exchange, was unequivocal that an affiliate of

> the Adviser could have become a member of the PBW Exchange. As such it could have received a substantial portion of commissions as an introducing broker, perhaps as much as 80%, and could have credited these against the advisory fee. At least until the abolition of reciprocals on July 15, 1973, *the member could also obtain PBW Exchange business from NYSE brokers in return for placing orders with them for execution on that exchange.* An exhibit showed that on March 5, 1973, PBW had 49 institutional members, including some nine who appear to have been affiliates of advisers or distributors of mutual funds.

Parenthetically, it may be noted that after the decision of the Court of Appeals and before the Report of the Master, Judge Frankel, in *Papilsky* v. *Berndt*, cited above, recognized the same item of damages now under discussion. After quoting a part of the PBW Constitution, Judge Frankel stated:

> "The evidence is clear, however, that this provision was not construed by the Exchange to prevent use of an affiliate which would be entitled to obtain membership on the PBW Exchange in order to act as an introducing broker for Affiliated Fund."

A footnote then continued:

> "In addition, such an affiliate could have obtained PBW Exchange business from NYSE brokers who wished a transaction executed on the PBW Exchange in return for placing orders with these brokers for execution on the NYSE."

The Master nevertheless declined to award any damages in this area. I am satisfied that in so declining, the able Master was in error.

The Report of the Master first concluded (p. 9) that any demand "to share commissions entailed considerable risks due to the delicately balanced financial and psychological factors inherent in the bargaining process of the securities market." I cannot

find any evidence which would support this conclusion. It seems clear that the system of fixed brokerage commissions, regardless of the number of shares or dollars involved, produced a substantial amount of "fat" which the executing brokers were willing to share in order to secure the large volume of investment funds.

The Master also concluded (Report, p. 9) that "possibilities for recapture appear to have been far fewer than plaintiffs contend." The evidence does not support this conclusion; on the contrary, the Court of Appeals decided on the evidence at trial that there could have been such recapture; so also did Judge Frankel in a similar case; and the expert (and only) witness for plaintiffs testified without contradiction that in fact he had done it.

The Master noted that although PBW Exchange was using possible recapture as an inducement to secure memberships, relatively few investment firms attempted recapture. The Master inferred from this that the arguments for the "potential for recapture are overly optimistic" (Report, p. 9). With great respect for the views of the Master, I feel that no such inference is justified. On the contrary, the more logical inference is that the reason recapture in this area was attempted by relatively few investment funds was because of the selfish and conflicting interests of their advisers which, as in the case of the Adviser here, followed age-old patterns of human nature and preferred to use the "fat" in the NYSE and Amex commissions for their own benefit rather than for the benefit of the funds. In point of fact, there were a number of large and prominent mutual funds whose advisers were recapturing brokerage commissions for the benefit of their funds. The SEC Report, quoted above and in the Court of Appeals opinion, mentions Investors Diversified Services (IDS), Waddell & Reed, Channing Financial Corp. and Imperial Financial Services. The witness for plaintiffs mentioned, in addition, Dreyfus Corp. (SM 62-63.)

The Master specifically based his refusal to find damages in this area on the failure of the expert witness for plaintiffs to "analyze the Fund's trading figures in detail to arrive at a reasonably precise proportion of recapturable trade commissions."

(Report, p. 9). The Master found that plaintiffs did not carry a burden "to elicit from their witness the detailed basis of his analysis, if there was any". (Report, p. 10.) I do not believe that any such "detail" or a "detailed analysis" of the Fund's "trading figures" would be meaningful. It is the total yearly volume of Fund commissions on NYSE and Amex transactions which is significant. This was in evidence and was used by the expert witness in arriving at his opinion.

The expert witness for plaintiffs was Jones, the President of the brokerage firm which was a wholly owned subsidiary of Waddell & Reed, one of the recapturing investment advisers mentioned approvingly in the SEC Report quoted in the opinion of the Court of Appeals. The job of the witness had been to recapture as much as possible of the brokerage commissions paid for stock transactions by the investment funds advised by Waddell & Reed. He worked at this job successfully for a number of years and, with his extensive background experience added in, was uniquely qualified to testify on damages in the case at bar. The Master correctly found that he could testify as an expert (SM 53; Fed. R.Ev. 702).

Before doing so, Jones told how Waddell & Reed secured, through its subsidiary, reciprocal brokerage from the brokers employed on NYSE. More than half the transactions of the funds advised by Waddell & Reed were on the NYSE. The subsidiary was a member of three regional exchanges—PBW Exchange, Midwest Exchange, and Pacific Coast Exchange. Some 50 brokers were employed by Waddell & Reed to execute transactions for their funds on NYSE. Jones arranged with them that they, in exchange for the NYSE business, would share with the Waddell & Reed subsidiary their own commissions on PBW Exchange and the other regional exchanges of which the subsidiary was a member. They were entirely agreeable to doing this, obviously because under the no volume discount-no fixed minimum commission rules, there was sufficient "fat" in their NYSE commissions to make it profitable for them to do so.

In 1968, most of the reciprocal brokerage was done "two for one" (SM 33), meaning that for every $1,000 in commissions for

fund transactions executed on NYSE, the fund affiliated member of a regional exchange (such as PBW) was given $500 in shared commissions on that regional exchange. Beginning in 1969, the share of the Waddell & Reed fund affiliate increased and in 1970 and thereafter was 75%, or $750 in shared commissions on a regional exchange for $1,000 in commissions on NYSE.

The evidence, in particular Exhibit 96, showed that in the relevant time period, the Waddell & Reed funds paid $114,474,000 in brokerage commissions on all exchanges and that $47,917,000, or about 42%, was recaptured.

Based on the opinion of the Court of Appeals and the evidence before the Master, damages must be awarded for failure of defendants to recapture through reciprocal brokerage. The amount is to be determined.

Jones was of the opinion that there could have been recovered for the Fund by way of reciprocal brokerage, approximately $3,250,000. He explained that out of the total commissions paid by the Fund, the executing brokers would keep 40% for their own expenses, including research, and that this would leave 60% as the maximum subject to recapture. Since the industry practice was to share for recapture on at least a two-for-one basis, one dollar surrendered by the executing broker for each two dollars in commissions, this meant that of the 60%, half or 30% would be the part recapturable by the Fund here.

According to Jones: "typical of the industry was a two for one deal" (SM 61). Any fund having at least $10,000 in brokerage commissions annually on its NYSE transactions could, according to Jones, have secured the two-for-one reciprocal brokerage recapture.

Applying 30%, the percentage obtained by the use of the two-for-one formula as shown above, to the total commissions paid by the Fund—after eliminating underwriter discounts, about which Jones said he knew nothing—the result was the $3,250,000 already given as the opinion of Jones. It was stated by Jones that his opinion was "conservative" (SM 118) and lower than what he was recapturing for Waddell & Reed. Jones explained that there

would be no expense involved in recapture and no necessity for the Fund PBW member to do anything except receive a "clearance ticket", what he called "a Philadelphia give-up" (SM 115).

The 30 percentage stated in the opinion of Jones as the percentage of total commissions which could have been recaptured for the Fund is justified by the evidence, including the other testimony of Jones. The dollar amount stated by him is subject to some adjustment for minor mistakes appearing on close examination of the figures in the record. The total Fund commission, as given to Jones from Exhibit 100, was $11,597,728.95 (SM 113). The figure has at least two errors: (a) it includes commissions on *all* exchanges whereas the only relevant commissions are those on NYSE and Amex; and (b) it includes underwriting discounts and tender fees which are not brokerage commissions and are not involved in the item here under consideration.

A figure of 20% as the recapturable percentage of NYSE and Amex commissions is a more conservative figure and will be adopted. Waddell & Reed were able to recapture 42% of the total commissions. The amount of their commissions was much larger than that of the Fund here. It is true that the evidence, including the testimony of Jones, establishes that the recapturable percentage did not increase in proportion to an increase in the amount of commissions. Among other evidence, this appears from a comparison of the yearly total commissions of the Waddell & Reed funds set out in Exhibit 96 with the percentage recaptured in each year. For example, the highest percentage of recovery is 57.6% in 1970 when the total commissions in that year were sixth in size for the eight years involved.

While the 20% amount may be to some extent unfair to plaintiffs, it avoids any possibility that the damages are fixed in an amount greater than could have been obtained by the defendants through recapture.

The starting figure for calculating damages in this area is the amount of commissions paid by the Fund in the relevant time period for the execution of its transactions on the NYSE and Amex. These are shown on Exhibit 100 by the three

figures (disregarding cents)—$1,805,341; $2,462,562; and $6,075,951—appearing in the "Totals" column on the extreme right of the exhibit. The grand total of these commissions is $10,343,854. Applying to this grand total the 20% recapturable factor yields the amount of $2,068,770 which is the damage award on this aspect of the claim of plaintiffs.

8.

The arguments for defendants, both oral and written, have each been carefully considered and must each be rejected as without merit. It would serve no useful purpose to discuss any of those arguments except one.

The principal argument for defendants is that on the evidence the Fund was much better off not recapturing than to have recaptured. I do not believe that, as a matter of law, this Court can entertain such an argument. It seems to me simply a repeat of the "business judgment defense" which was "foreclosed on the issue of liability because of lack of effective disclosure to unaffiliated directors" (533 F.2d at 756). It is an attempt to reargue in this Court the decision of the Court of Appeals.

Could I consider the argument, it could not be found supported by the evidence. There is nothing in the record to show that there would have been any detriment whatever to the Fund had the Adviser recaptured for the Fund what could easily have been obtained. The defendants were motivated in making no effort to recapture, by a desire to advance their own interests and not by a desire to serve the interests of the Fund.

9.

The Master correctly allowed as an offset what it would have cost to qualify the Adviser as a member of PBW Exchange and of NASD (Report, pp. 15, 16).

10.

The Master correctly found (Report, p. 4) that no evidence would justify a distinction between the defendants as to the extent of their liability. The judgment will be against all of the defendants in the same amount.

11.

The amount of the judgment will be the aggregate of the separate sums above determined, less the amount of the offset allowed by the Master. (Cents will be disregarded.)

The damages by year from failing to recapture introducing broker commissions through membership in PBW Exchange are shown in the Master's Report (p. 7) in Table 2.

The damages by year from failing to recapture tender offer fees are shown in the Master's Report (p. 8) in Table 3.

The offsets allowed by the Master are shown by years in the Master's Report (p. 16) in Table 6.

Because this Court has reduced the damages allowed by the Master from failing to recapture "underwriting discounts", these must be recalculated by years. According to my calculations, the damages on this item are by years as follows:

1967	$ 4,377
1968	32,982
1969	80,861
1970	16,273
1971	5,095
1972	6,469
1973	1,724
	$147,781

(Because cents have been disregarded, there is a small difference between this total figure shown above and the total stated in section 6 of this opinion.)

Since the Master did not allow damages from failing to recapture reciprocal commissions, it is necessary to calculate these by years. According to my calculations, the damages on this item are by years as follows:

1967	$ 274,664
1968	498,741
1969	426,630
1970	374,691
1971	310,433
1972	154,066
1973	29,541
	$2,068,766

(Because cents have been disregarded, there is a small difference between this total figure shown above and the total stated in section 7 of this opinion.)

The total damages by years after allowing for offsets are calculated as follows:

1967	$ 306,196
1968	537,964
1969	559,330
1970	424,616
1971	337,546
1972	171,454
1973	30,531
1974	2,720
	$2,370,357

Subject to correction for arithmetical errors in my calculations (and counsel are asked to verify these), judgment will be entered in favor of American Investors Fund, Inc. and against defendants, Chestnutt Corporation, Chestnutt, Jr., Sabel, Greene, and Currier in the sum of $2,370,357.

Interest is allowed on damages from the end of each year; the amount of damages will be accumulated as of the end of each year; the interest will be at the legal rate in effect at the end of each year except that after the end of the year 1974 interest will be at the legal rate in effect from time to time.

Counsel should be able to agree on the form of judgment. If agreement is not possible, proposed forms of judgment should be submitted at my chambers in Room 2903 not later than 11 a. m. on Thursday, June 26, 1980.

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

MAGISTRATE'S REPORT

68 Civ. 2855 (CBM)

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs,

-against-

GEORGE A. CHESTNUTT, JR., *et al.*,

Defendants.

This is a determination of damages in a derivative action brought by plaintiffs as stockholders of American Investors Fund, Inc. (the Fund) against the investment advisor of the Fund (the Advisor) and against George A. Chestnutt, Jr., Stanley Sabel, Warren K. Greene and John Currier, who were directors of the Fund and stockholders of the Advisor. The action concerns the duty of the managers of a mutual fund to recapture brokerage commissions paid on trades of shares in the Fund's portfolio and to apply the money recaptured for the benefit of the Fund. Damages are to be assessed for defendants' breach of their fiduciary duty to inform Fund directors not affiliated with the Advisor of the possibility of recapture.

The issue of liability was tried by Judge Inzer B. Wyatt, who dismissed plaintiffs' claim on the merits. *Fogel* v. *Chestnutt*, 383 F.Supp. 914 (S.D.N.Y. 1974). The Second Circuit reversed, finding liability on the part of the above named defendants, and remanded to the district court for determination of damages, 533, F.2d 731 (2d Cir. 1975). The Supreme Court denied *certiorari*, 429 U.S. 824 (1976), and after the remand Judge Wyatt, pursuant to Fed. R. Civ. P. 53, ordered the matter referred to the undersigned as Special Master "to determine the damages herein and to file his report thereon with findings of fact and conclusions of law." This case was reassigned to Judge Constance Baker Motley upon Judge Wyatt's retirement.

The factual situation underlying the finding of liability is set forth in Judge Wyatt's opinion at 383 F.Supp. 914 and in the reversing opinion of the Second Circuit at 533 F.2d 731. Familiarity with those opinions will be assumed.

I.

LIABILITY

Plaintiffs asserted two theories of liability for defendants' failure to make efforts to recapture. The first theory was based on contract and alleged that defendants had violated the terms of the Fund's certificate of incorporation. This claim was rejected by the Second Circuit, which did, however, find defendants liable on plaintiffs' second theory, breach of fiduciary duty, holding that "the [Investment Company] Act implicitly established a federal standard of fiduciary duty in respect of dealings between a mutual fund and its adviser," and that this fiduciary duty explicitly applied "with respect to the receipt of compensation for services" under the terms of § 36 thereof, 15 U.S.C. § 80A-35(b), added by amendment in 1970. The court also said that

> under the scheme of the Investment Company Act an investment advisor is "under a duty of full disclosure of information to . . . unaffiliated directors in every area where there was even a possible conflict of interest between their interest and the interests of the fund . . ."

533 F.2d at 745 (citations omitted).

The court decided that from the time of issuance of the SEC Report on the Public Policy Implications of Investment Company Growth, H.R. Rep. No. 2337, 89th Cong. 2d Sess. (1966), defendants were on notice to the possibility of recapture of sales commissions and had a fiduciary duty to carefully investigate the possibilities of recapture and communicate their findings to the Fund's independent directors, i.e., to those directors not affiliated with the Advisor. It was the conclusion of the Second Circuit that communication was not sufficient from the affiliated to the unaffiliated directors as to the possibility of recapture of sales commissions. 533 F.2d at 749.

Defendants' liability was not predicated on failure to recapture, but on failure to effectively communicate information to the independent directors so they could decide whether or not to recapture. The Second Circuit observed that had the independent directors been fully informed they might have decided, in the exercise of reasonable business judgment, not to recapture, but the court held that, because defendants were in breach of their fiduciary duty to inform, they would not be permitted to raise as a defense the hypothetical possibility of such an exercise of business judgment. 533 F.2d at 750.

Underlying its conclusion that a breach of fiduciary duty had occurred was a finding by the Second Circuit that recapture would have been both possible and legal. The court determined that the Advisor or an affiliate could have achieved membership in the National Association of Securities Dealers (NASD), and, as such, would have been entitled to receive give-ups of a percentage of the brokerage commissions generated by the fund's transactions executed on the Philadelphia-Baltimore-Washington (PBW) and Pacific Exchanges. It also found that PBW membership was available to the Advisor.

The court held, too, that once NASD membership had been obtained, recapture by recovery of tender offer fees would have been possible, and that, once recaptured, such fees should have inured to the benefit of the Fund.

The Second Circuit suggested that primary liability should be imposed on the Advisor, and that defendant Currier's liability was of a lesser degree than that of the other individual defendants, but it did not rule on the apportionment of liability. Because all defendants were represented by the same attorney during these proceedings, and no proof of individual responsibility was introduced, a finding of degrees of fault of the individual defendants is not feasible.

II.

THE MANDATE ON DAMAGES

The court held that defendants' liability was to commence March 1, 1967, ending on December 5, 1968 for failure to utilize NASD membership to recapture give-ups and on March 29, 1973 for failure to recapture through membership on the PBW Exchange. The opinion left to the district court the selection of a termination date of liability for failure to recapture tender offer fees. 533 F.2d at 755.

The charge of the undersigned in determining damages is to attempt the "difficult but ineluctable" task "of seeking to find what would have been," 533 F.2d at 755, mediating between the conflicting principles

> that while "a defendant whose wrongful conduct has rendered difficult ascertainment of precise damages suffered by the plaintiff is not entitled to complain that they cannot be measured with the same exactness and precision as would otherwise be possible," *Eastman Kodak Co.* v. *Southern Photo Materials Co.*, 273 U.S. 359, 379 (1927), yet recovery "cannot be had unless it is shown, that, as a result of defendant's acts, damages in some amount susceptible of expression in figures resulted." *Keogh* v. *Chicago & Northwestern Ry.*, 260 U.S. 156, 165 (1922).

533 F.2d at 756 (footnote and parallel citations omitted).

As to tender fees and business the Fund actually conducted on the PBW and Pacific Coast Exchanges, the Second Circuit followed the *Kodak* rule quoted above, holding that the only issue to be determined by the undersigned is the amount of such business conducted and the amount recapturable as a result of that business. 533 F.2d at 756.

The court also took cognizance of the second of the above quoted "conflicting principles," the *Keogh* rule, in declaring that

> if plaintiffs desire to pursue the path . . . of urging that the Adviser should have routed more of Fund's business to the

> PBW and Pacific Coast Exchanges, and of endeavoring to estimate what would have been recapturable if it had . . . defendants should be allowed to develop the practical arguments against doing this, although not to relitigate the issues of possibility and legality of recapture.

533 F.2d at 756.

III.

PLAINTIFFS' CLAIMS

Plaintiffs argue that several areas of recapture were available which, if pursued, would have resulted in substantial recoveries for the benefit of the Fund. Each area will be separately discussed.

A. Recapture of PBW Commissions and Tender Offer Fees

The Second Circuit found that the Advisor could have created a brokerage affiliate which would have been eligible for membership on the PBW Exchange and could have acted as introducing broker on all of the Fund's transactions which were actually executed on the PBW, so that recapture for the benefit of the Fund of "perhaps as much as 80%" of the commissions on these transactions was possible. It was similarly found that NASD membership was available to the Advisor, which could have recovered tender offer fees by that same means. 533 F.2d at 752. The court foreclosed defendants from submitting proof on the legality, possibility or business wisdom of engaging in recapture in these two areas, so that the inquiry on damages is limited to an accounting.

The Fund paid commissions on the PBW between March 1, 1967 and March 29, 1973 as follows:

Table 1

1967	$ 40,237.57
1968	13,183.21
1969	23,949.59
1970	47,071.74
1971	34,404.54
1972	20,530.37
1973	802.75
Total	$180,179.77

Plaintiffs claim that 80% of this amount was recoverable for the benefit of the Fund, the remaining 20% representing executing and clearing charges. The claim for damages, year by year, is thus:

Table 2

1967	$ 32,190.06
1968	10,546.56
1969	19,159.67
1970	37,657.39
1971	27,523.63
1972	16,424.30
1973	642.20
Total	$144,143.81

Although defendants' witnesses testified that executing and clearing charges would exceed 20%, their estimates conflict with other testimony and with the tentative conclusion of the Court of Appeals that approximately 80% of the amount recaptured on the PBW could have been applied for the benefit of the Fund. I adopt 20% as the amount attributable to executing and clearing of PBW transactions and find damages in the amounts listed in Table 2.

The fund paid tender offer fees as follows:

Table 3

1968	$ 1,200.00
1969	38,185.50
1970	1,500.00
1971	-0-[1]
1974	3,000.00
Total	$43,885.50

The Second Circuit left to the district court a decision as to whether liability for failure to recapture tender offer fees should terminate short of the day of judgment. I find no reason to limit the time during which the unexploited potential for recapture gave rise to damages and award tender offer fees paid through 1974.

B. Reciprocal Brokerage and Crosses

Plaintiffs' expert witness was asked to analyze the Fund's trades and to determine how much of the commissions it generated could have been recaptured through reciprocal brokerage and crosses had the Fund pursued these options fully. He reasoned that 40% of the total commissions would not be amenable to recapture deals, since that amount would be needed as a trade-off for research or other services, but that of the 60% which remained, recapture at the rate of two for one would result in recovery of an amount equal to 30% of the total, or $3,250.00.

Demands to share commissions entailed considerable risks due to the delicately balanced financial and psychological factors inherent in the bargaining process of the securities market, and the possibilities for recapture appear to have been far fewer than plaintiffs contend. During the period at issue in this suit only about one in eight or ten mutual funds was recapturing although the potential for recapture was generally known (Tr. 245), and

1. In 1971, $1,297.25 in tender fees was paid by the Fund. In 1972, this amount was refunded in its entirety.

although the PBW was actively soliciting members and using the possibility of recapture as a selling point. This evidence raises an inference that plaintiffs' arguments in regard to the Fund's potential for recapture are overly optimistic.

Plaintiffs' expert did not analyze the Fund's trading figures in detail to arrive at a reasonably precise proportion of recapturable trade commissions. Instead, he looked at the figures presented to him as a whole and in some subjective fashion arrived at the conclusion that a recapture of 30% was possible. It was clearly plaintiffs' burden to elicit from their witness the detailed basis of his analysis, if there was any. This they failed to do.

The recapture of commissions for reciprocal brokerage and crosses is not one of the areas referred to by the Second Circuit as compelling defendant to bear the consequences of the impossibility of measuring damages with exactness and precision. 533 F.2d at 756. The testimony presented at trial leaves no doubt that some recapture possibilities existed for the advisor with an eye eager to discern them, but plaintiffs have failed to meet their burden of presenting a convincing *prima facie* case. Accordingly, they should not recover damages on this claim.

C. Underwriting Discounts, Commissions and Allowances

During the time period at issue the Fund paid underwriting discounts, commissions and allowances in the following amounts:

Table 4

1967	$ 21,887.40
1968	164,911.00
1969	404,308.25
1970	81,365.00
1971	25,479.75
1972	32,345.80
1973	8,624.00
Total	$738,921.20

This area of recovery was not specifically addressed in the Second Circuit's mandate on damages. Plaintiffs argue that all that was required to effectuate recapture of these amounts was the establishment of a brokerage affiliate with NASD membership and the designation of that affiliate to be included as a member of the underwriting or selling groups which marketed the stocks in which the Fund invested. As a member of the selling group, the affiliate would have been eligible to share in the earnings of the group which were generated by the Fund's purchases, but would not have been required to do any actual work in marketing the issues. Commissions paid to the affiliate pursuant to an underwriting could have been transmitted to the Advisor in the form of dividends paid by the affiliate and the advisory fee due from the Fund to the Advisor would then have been credited in the amount of the dividend.

Although the Second Circuit limited defendants to raising practical business arguments against recapture and precluded relitigation of its possibility and legality, 533 F.2d at 756, such an inquiry is necessary as to the recapturability of underwriting fees, as the subject was not specifically considered in the court's opinion.

Turning first to the question of the possibility of such recapture, NASD membership was available to an affiliate of the Advisor, had one been created. 533 F.2d at 752. Another prerequisite to recapture of underwriting discounts was that the Advisor have sufficient leverage to effectively demand that its affiliate be designated as a member of the selling group.

On the evidence presented at the hearing, I am of the opinion that the Advisor possessed the degree of leverage which could have returned a portion of the amount paid for underwriting discounts, commissions and allowances, through an affiliate.

Defendants argue that recapture of underwriting discounts by NASD members would have been illegal, but their contention is predicated on the assumption that recapture would have been accomplished for the direct benefit of the Fund. Testimony revealed that under the rules of the NASD it would be improper

for a broker acting on behalf of a mutual fund to transmit to the fund, either in cash or by way of crediting an advisory fee, the full amount of an underwriting discount which it received (Tr. 1166-67), but there was also evidence that if a broker were wholly owned by an advisor and transmitted its profits to the advisor as a bona fide dividend, there would be no impropriety even if these profits were earned by recapture of underwriting discounts (Tr. 1167-68). It is my conclusion, therefore, that defendants' arguments do not require a finding that recapture of underwriting discounts in the manner suggested by plaintiffs would have violated NASD rules. Instead, I am led to the contrary conclusion that a properly constituted broker-affiliate could have received underwriting discounts and transmitted its profits to the Advisor as dividends which could be credited against the advisory fee to the Fund's benefit.

The weight of the evidence leads to a finding that at least 25% of the underwriting discounts, commissions and allowances, as set forth in Table 4, were recoverable. While here, too, there is a lack of precision in arriving at the set figure, I find that this percentile figure is a reasonably low one in view of the leverage that the Advisor could have mustered in seeking such recapture. The amounts thus recoverable (25% of the figures in Table 4) are set forth in the following table:

Table 5

1967	$ 5,471.85
1968	41,227.75
1969	101,077.06
1970	20,341.25
1971	6,369.94
1972	8,086.45
1973	2,156.00
Total	$ 184,730.30

IV.

DEFENDANTS' CLAIMS AND OFFSETS

In addition to their contentions regarding the individual areas of recapture suggested by plaintiffs, defendants raise two arguments which, they claim, totally negate damages in this case.

A. Increase in the Fund's Net Asset Value

Defendants argue that the allocation of brokerage commissions to reward brokers who sold the Fund's shares increased the total net assets of the Fund and thereby decreased the per share cost of the Advisor's fees (Tr. 360-64). This decrease was greater, the defendants claim, than the per share benefit the Fund's shareholders would have enjoyed from recapture. Arguing the Advisor could not have both recaptured and decreased the per share advisory fee in this manner, it is defendants' position that shareholders were not damaged by the failure to recapture.

Despite defendants' theory, there was testimony that it might have been possible to increase the Fund's net asset value by recapturing, using the fact of recapture to promote sales of Fund shares (Tr. 547). Thus, the Advisor might have engaged in recapture and advertised that fact as a demonstration of the competence of the Fund's management, thereby simultaneously recapturing commissions and increasing the Fund's net asset value.

The premise of defendants' theory is that there was a correlation between increase in the total net assets of the Fund and decrease in the per share advisory fee cost. A year-by-year study of the relationship between the Fund's total net assets and the per share advisory fee charged reveals, however, that there was no clear relationship between a rise or fall in total net assets and savings to the Fund's shareholders in per share advisory fee costs. If any savings did result, factors other than the increase in the Fund's total net assets by failure to recapture must have played a part.

B. Cost of Operation of Broker-Affiliate

Defendants' second claim in negation of damages is that creation of a broker-affiliate would have entailed costs far in excess of the benefits available through recapture. One of defendants' witnesses, an employee of the defendant corporation, prepared documents in evidence as exhibits B-1 through B-4, which purport to allocate portions of the Advisor's salaries and expenses attributable to a PBW broker-affiliate had one been created. Exhibit B-5 sets forth additional expenses allegedly required to set up and run a PBW affiliate.

I reject the figures set forth in exhibits B-1 through B-4, as these expenses were already borne by the Advisor and were considered in computing the Advisory fee paid by the Fund shareholders. A bookkeeping shift allocating these expenses to the PBW affiliate would not recreate them as additional expenses. Similar considerations compel dismissal of the tax expenses alleged in exhibits C-1 through C-4.

As to the additional expenses set forth in exhibit B-5, I reject the unquantified claims for floor brokerage and clearance. No such expenses would have attended the recapture of tender offer fees or underwriting discounts, and these expenses have already been accounted for in my findings with regard to PBW brokerage. I further discount the cost of a CCH Subscription. The other expenses listed in exhibit B-5 appear reasonable.

Accordingly, the establishment of a PBW broker-affiliate and NASD membership would have resulted in an initial year expense to the Advisor of $6,043 and a subsequent yearly expense of $5,505, from 1968 through 1973. NASD membership in 1974 would have cost $280. Expenses for the first year must be diminished by one-sixth since liability began on March 1, 1967, and the expenses for the final year must be diminished by 75% since liability generally ended on March 31, 1973. Thus, the following amounts should be set off against damages as found:

Table 6

Yearly Expenses of a Broker-Affiliate

1967	$ 5,035.82
1968	5,505.00
1969	5,505.00
1970	5,505.00
1971	5,505.00
1972	5,505.00
1973	1,376.25
1974	280.00
Total	$ 34,217.07

V.

DAMAGES AND INTEREST

I find the yearly total of damages to be as listed below in Table 7, which has been derived by adding the yearly damages found in Tables 2, 3 and 5 and subtracting from each yearly total the offsetting expenses attributable to that year as shown on Table 6.

Table 7

1967	$ 32,626.09
1968	47,939.81
1969	152,917.23
1970	53,993.64
1971	28,388.57
1972	29,005.75
1973	1,421.95
1974	2,720.00
Total	$349,013.04

Interest shall be computed on the damages accruing in each year on an accumulating basis according to the legal rates in effect at the end of each year.

The foregoing constitutes my findings of fact and conclusions of law.

Respectfully submitted,

SOL SCHREIBER
Sol Schreiber
United States Magistrate

Dated: New York, New York
October 31, 1978

ROSALIND FOGEL AND GERALD FOGEL,
Plaintiffs-Appellants,

v.

GEORGE A. CHESTNUTT, JR., *et al.*,
Defendants-Appellees.

United States Court of Appeals,
Second Circuit.

Argued Sept. 22, 1975.
Decided Dec. 30, 1975.

No. 39, Docket 74-2582.

Before FRIENDLY, HAYS and FEINBERG, Circuit Judges.

FRIENDLY, Circuit Judge:

More than four years after the First Circuit decided *Moses* v. *Burgin*, 445 F.2d 369 (1971), reversing 316 F.Supp. 31 (D.Mass. 1970), concerning the duty of the managers of a mutual fund to recapture brokerage commissions for the benefit of the fund, this court is confronted with the problem for the first time. In reviewing Judge Wyatt's dismissal on the merits of a recapture action in the District Court for the Southern District of New York, 383 F.Supp. 914 (1974), we must determine whether we agree with the First Circuit's decision and, if so, whether it applies to the somewhat different facts here at issue. With some qualifications our answers to both questions are in the affirmative. We therefore reverse and remand for the determination of damages.

I.

THE ROOT OF THE PROBLEM

The present is one of what we understand to be a large number of derivative stockholders actions brought on behalf of mutual funds against investment advisers, distributors, and directors of

both,[1] primarily in consequence of remarks in the SEC's Report on the Public Policy Implications of Investment Company Growth (PPI) 16,172-73 (1966), House Report No. 2337, 89th Cong.2d Sess.

The basic factual situation giving rise to the recapture problem is well described in Judge Wyatt's opinion, 383 F.Supp. at 916-18, in the opinion of Judge Wyzanski, 316 F.Supp. 31 (D.Mass.1970), and the reversing opinion of the First Circuit in *Moses* v. *Burgin, supra* in PPI, and in countless law review notes and articles both before and after *Moses*.[2] Accordingly we shall endeavor to be brief in our statement of the problem and will assume familiarity with the typical structure of the externally managed open-end mutual fund, a mere shell whose investment and management functions are performed by an adviser and whose sales are handled either by the adviser (or the fund itself) in the case of no-load funds or by a distributor (which may or may not be identical with the adviser) in the case of load funds.

At the root of the recapture problem was the historic practice of the New York Stock Exchange (NYSE) and other exchanges of charging a fixed rate of commission on each share traded regardless of the size of the transaction (except for the odd-lot differential). Since the costs of executing an order do not vary in

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1. A 1971 article stated there had been fifty. Butowsky, Fiduciary Standards of Conduct Revisited—*Moses* v. *Burgin and Rosenfeld* v. *Black*, 17 New York Law Forum 735, 736 (1971), see also Comment, Mutual Funds and Independent Directors: Can Moses Lead to Better Business Judgment, 1972 Duke Law Journal, 429, 430 n. 8. Some such suits have been settled, *e.g.*, *Weiss* v. *Chalker*, 55 F.R.D. 168 (S.D.N.Y. 1972), 59 F.R.D. 533 (S.D.N.Y. 1973). Another action has recently been dismissed on the merits, although on grounds differing, at least in considerable part, from those adopted by the district court in the instant case. *Tannenbaum* v. *Zeller*, CCH Federal Securities Law Reports ¶95,257 (Carter, D. J., 1975).

2. In addition to the articles cited in n. 1, see The Use of Brokerage Commissions to Promote Mutual Fund Sales, 68 Colum.L.Rev. 334 (1968); Conflict of Interest in the Allocation of Mutual Fund Brokerage Business, 80 Yale L.J. 372 (1970); Miller and Carlson, Recapture of Brokerage Commissions by Mutual Funds, 46 N.Y.U.L.Rev. 35 (1971); Fiduciary Obligations of Mutual Fund Managers in Portfolio Transactions, 22 Syracuse L.Rev. 1107 (1971); Note, 60 Georgetown L.J. 1594 (1972); Note, 13 Wm. & Mary L.Rev. 530 (1971).

accordance with size, the large sales and purchases at the command of investment advisers of mutual funds were particularly attractive orders. At first fund managers allocated their brokerage business to reward brokers who had been helpful in selling the fund's shares, in furnishing advice, or in doing both,[3] orders allocated as rewards were known as "reciprocals." However, as the business grew, the practice of reciprocals resulted, especially for the large funds, in using too many brokers, some of whom were not the best qualified to execute the particular order placed with them. Hence there developed the practice of relying on a few executing brokers who were then instructed to "give-up" a portion of their commissions, sometimes as much as 75%, to another broker whom the fund manager wished to reward. On NYSE this was permitted only in favor of another member, but six of the seven regional exchanges permitted "give-ups" in favor of non-members as well, provided they were members of the National Association of Securities Dealers, Inc. (NASD).

There was an obvious tension between the give-up and those representations made by the investment company in its prospectuses which investors would be likely to understand as meaning that the amounts paid to the investment adviser constituted the fund's cost for management and investment advice and, in the case of "load" funds, that the amounts retained by the distributor constituted the cost of sales. In fact, the management-directed "give-ups" to non-executing brokers represented additional amounts that were being paid for advising, selling or both, and the true costs of these services were thus higher than the advisory fee or the sales load. To the extent that a management company restricted its own research because of what was being furnished by brokers who were rewarded with give-ups or that a distributor retained for itself a larger part of the sales load than would have been competitively feasible in the absence of give-ups, the stipulated management fees yielded greater profits than they otherwise would have. The practice entailed other evils unnecessary here to detail. Still, if there was no way for a fund to "recapture" the

3. Some brokers rendered other services, such as making the required daily computation of the fund's net asset value, see PPI at 164.

excess of the fixed and unvarying commissions over what the executing broker would willingly accept, something was to be said for using the excess to reward brokers who had served the fund in some fashion rather than simply overpaying the executing broker. The SEC put its finger on the problem as early as 1963 when it said in its Report of the Special Study of Securities Markets, House Doc. No. 95, 88th Cong. 1st Sess. p. 234:

The Special Study concludes and recommends:

> 1. The pattern of reciprocal business in the mutual fund industry is unique. The economies of the volume of securities transactions generated by the mass purchasing power of the funds for the most part are of minor benefit to the funds themselves. The primary beneficiaries are their investment advisers and their frequently related principal underwriters, who to a large extent use reciprocity to reward the sales efforts of fund retailers, thereby increasing their own rewards. The use by fund advisers of investment advice and research provided by brokerage firms in return for fund brokerage, without diminution of their investment advisory fees, is another indication of the manner in which they are the primary beneficiaries of reciprocal business. This unbalanced reciprocal structure is a direct outgrowth of a minimum commission rate structure which prohibits volume discounts and rebates. In the broad study of the commission rate structure recommended to the Commission in chapter VI-I, appropriate consideration should be given to the desirability and appropriate form of a volume discount from the viewpoint of mutual funds.

As developed by Mr. Justice Blackmun in *Gordon* v. *New York Stock Exchange, Inc.*, 422 U.S. 659, 690, 95 S.Ct. 2598, 45 L.Ed.2d 463 (1975), 43 U.S.L.W. 4958, 4961-62, reform of the commission rate structure had a long gestation period. Meanwhile a few adviser-underwriters decided to recapture for their funds some of the spread between the fixed and unvarying commissions payable to executing brokers and the lesser amounts the

latter were willing to accept on large orders. In a discussion of this development, at 172-73, PPI echoed the Special Study's criticisms of mutual fund reciprocal and give-up practices and continued in a passage meriting full quotation, pp. 172-73:

(a) Use of brokerage commissions to benefit the funds

(i) *Reducing advisory fees.*—As has been noted, subsidiaries of four adviser-underwriters that maintain their own retail sales forces—among them three of the largest, Investors Diversified Services, Inc., Waddell & Reed, Inc., and Channing Financial Corp., as well as the smaller Imperial Financial Services, Inc.—are now members of the Pacific Coast Stock Exchange. These subsidiaries execute orders for the funds on the Pacific Coast Stock Exchange. More important, however, they obtain a considerable amount of nonfund business from broker-dealers who are dual members of the Pacific Coast Stock Exchange and other exchanges in return for fund brokerage business on other exchanges, primarily the NYSE. All the net profits of IDS's subsidiary and about 40 to 50 percent of the net profits of Waddell & Reed's and of Imperial Financial Services' subsidiaries have been applied to reduce advisory fees payable by the funds in those complexes.

Widespread emulation by institutional investors of the precedent set by these four complexes could have a marked effect on the economics of the securities industry. Within the framework of the existing commission rate structure it is a method whereby mutual fund shareholders can derive greater benefits than they have heretofore received from fund brokerage commissions. However among dealer-distributed funds the important role that portfolio brokerage plays in the competition for dealer favor has kept fund managers, with few exceptions, from using exchange memberships to reduce costs of the funds.

Similar competitive factors have also operated against the use, for the benefit of the funds and their shareholders,

> of regional exchange rules permitting give-ups to any member of the NASD on transactions executed on those exchanges. It would not be inconsistent with those rules for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the funds. Unless and until such procedures become widespread, any adviser-underwriter to a dealer-distributed fund who chose to utilize fund brokerage in this manner would place itself at a disadvantage in competing for the interest of nonmember dealers in selling the fund shares which it distributes. (Footnotes omitted.)

This passage followed an earlier summary in which PPI had written, beneath the heading "(c) Impact of mutual fund reciprocal and give-up practices," p. 16:

> Under existing commission rate structures, mutual fund shareholders could derive greater benefits from their brokerage commissions if the give-up portions of the commissions were transmitted to the funds themselves or their adviser-underwriters for the purpose of reducing management costs. However, in the face of competitive pressures managers of the dealer-distributed funds have not used brokerage for this purpose. (Footnote omitted).

Postponing further developments on the SEC front for discussion in Part III of this opinion, we turn with this background to the case at hand.

II.

THE PROCEEDINGS IN THE DISTRICT COURT

This action was brought in July, 1968 by two stockholders of American Investors Fund, Inc. (the Fund) on behalf of the Fund. The Fund is a diversified open-end, no-loan management investment Company registered under the Investment Company Act.

From the date of its organization in 1957 until July, 1966, its investment adviser and manager was American Investors Corporation; since that date the adviser and manager has been Chestnutt Corporation. We shall refer to the two collectively as the Adviser. The chief figure both in the Fund and the Adviser has been George A. Chestnutt, Jr. The amended complaint alleged that as a result of the growth of the Fund, fees paid to the Adviser rose from such modest amounts as $93,347 in 1963 and $187,083 in 1964 to figures exceeding $1 million in the period 1967-70, the highest being $1,557,000 in 1969.

The supplemental complaint continued with allegations concerning the Fund's brokerage fees and the "allocations" of these, as shown in the following table[4]

	Brokerage fees	Allocated to brokers who had provided helpful information	Allocated to brokers who had assisted in the sale of Fund Shares
1964	$ 275,000	$ 162,000	$ 113,000
1965	387,000	247,000	140,000
1966	551,668	261,913	289,755
1967	1,995,087	935,966	1,059,121
1968	3,122,160	2,022,457	1,099,703
1969	2,489,281	1,196,059	1,293,222
1970	2,059,234	1,108,667	950,000

The supplemental complaint[5] continued that, by awarding reciprocal brokerage, sales of Fund shares are stimulated (with attendant increases in the advisory fee), and brokers are used to furnish advisory services the Adviser is obligated to provide.

4. Since the sum of the second and third columns approximately equals the first, they substantially overstate the amount of commissions that would have been recaptured on any view.

5. A separate action, *Fogel* v. *Chestnutt*, 67 Civ. 60 (S.D.N.Y.), was brought in January, 1967, charging that I.O.S. Ltd., there a defendant, had caused a corporation which it dominated to cause the Fund to use a particular broker when that broker's research and advisory services were channeled to I.O.S. and not to the Fund. See *Fogel* v. *Chestnutt*, 296 F.Supp. 530 (1969). This case was "statistically closed" on April 25, 1975.

Thus the Adviser has in effect received compensation exceeding the amounts provided in the investment advisory contract. Although an affiliate of the Fund or the Adviser could have been empowered to act as the Fund's broker and save a portion of the brokerage commission, this was not done because the Adviser "prefers to profit from such brokerage transactions used to pay its obligations by awarding the Fund's brokerage commissions to others." In what is probably its crucial paragraph the supplemental complaint alleged:

> The Fund or the Investment Adviser could have organized an affiliate for the purpose of reducing the net brokerage commissions paid by the Fund. This affiliate could have recaptured the Fund's brokerage commissions on various regional exchanges since at least January, 1965. Defendants Chestnutt, Sabel, and Greene intentionally misled and misinformed the Fund's unaffiliated directors by telling them that such recapture was not available to the Fund.

The adviser and four of its directors—Chestnutt, Sabel, Currier and Greene—who had been served filed an answer denying most of the non-formal allegations of the complaint and pleading various affirmative defenses. The only one of importance was:

> 27. The Fund has received the benefit of brokerage services equal in value to the brokerage commissions paid by it at the regular, customary and required minimum rates for transactions on national securities exchanges, and the Fund has received the benefit of brokerage services equal in value to brokerage commissions paid by it in accordance with regular and customary rates obtaining in other markets, all in accordance with rules and regulations of national securities exchanges and associations authorized and empowered by law to determine brokerage practices, rates and procedures, and this action may not be maintained.

Although the parties had initially demanded a jury trial, this was waived. A pretrial order directed that the issue of liability be tried separately. Various facts were stipulated. These included that until 1971 defendant Stanley L. Sabel was senior vice president, secretary and a director of the Fund, and vice president, secretary, general counsel and a director of the Adviser; that his law firm of Sutton, Sabel & Schupp became counsel to the Fund about 1966, and that Sabel owned 16% of the stock of the Adviser; that Clendon H. Lee, whose wife owned 1% of the stock of the Adviser, was special counsel to and a director of the Adviser, became special counsel to the Fund in 1965, and had acted since 1967 as counsel for the Adviser and the served defendants in this action; and that defendant Currier owned 2% of the stock of the Adviser. The stipulation included facts as to the acquisition of membership in the Pacific Coast Exchange and the reduction of advisory fees through the recapture of commissions by Waddell & Reed, Inc., Investors Diversified Services, Inc., the Channing Complex, and Imperial Financial Services, substantially as stated in PPI, pp. 1314-1316 supra. There was also a stipulation concerning the degree of consideration given to recapture by the directors of the fund and the advice on that subject by Sabel and Lee, of which more hereafter. There was some narrowing of plaintiffs' contentions and a 17-paragraph statement of defendants' answers.

After trial Judge Wyatt rendered an opinion dismissing the action on the merits, 383 F.Supp. 914. Accepting the principle "that defendants were under a duty by all proper means to secure for Fund the return of excess brokerage commissions," he concluded it had not been shown "that defendants could have properly secured any return for Fund," 383 F.Supp. at 920. Assuming *arguendo* that *Moses* v. *Burgin* had been correctly decided, he viewed it as distinguishable on the ground that the fund there concerned was a load fund whose shares were sold by an affiliated underwriter, who was qualified as a "dealer" within the NASD definition of that term and who was in fact a member of the NASD entitled to receive customer-directed give-ups on

certain regional exchanges until the abolition of such give-ups on December 5, 1968. Recognizing that NASD membership was not required for membership on the Philadelphia-Baltimore-Washington Exchange, Judge Wyatt ruled that such membership[6] "would require defendants to pretend that the new subsidiary was a broker, when in fact it was not, for the purpose of securing a preference over other investors by recapturing a part of the fixed commissions" and that this would have run counter to public policy, 383 F.Supp. 920-21. The plaintiffs have appealed.[7]

III.

Before analyzing the legal issues it will be convenient to update the discussion of administrative developments in Part I of this opinion, which we left with the publication of PPI at the end of 1966. A year later the SEC announced in Release No. 8239 that it had under consideration proposed Rule 10b-10, an effort to implement the suggestion put forward in PPI, which we have quoted, that "it would not be inconsistent with [the] rules [of certain regional stock exchanges] for dealer-distributed funds to direct give-ups to their adviser-underwriters, all of whom are

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6. Institutional memberships, with some exceptions, were prohibited following the adoption of Rule 19b-2 which ultimately became effective March 29, 1973, under the Securities Exchange Act of 1934, see 17 C.F.R. § 240, 19b-2 (1973).

7. We decline to yield to defendants' urging that we make a "threshold" disposition without reaching the merits, on the ground of plaintiffs' failure to allege with sufficient "particularity" their efforts to obtain action from the directors or their reasons for failing to do so, as required by F.R.Civ.P. 23.1; cf. *Brody* v. *Chemical Bank*, 482 F.2d 1111 (2 Cir. 1973). Defendants refer to our decision in *Papilsky* v. *Berndt*, 503 F.2d 554 (2 Cir. 1974), as having "carefully reserved the right *after trial* to obtain judgment of dismissal for failure to comply with Rule 23.1" (emphasis in original), Defendants-Appellees' Brief at 31. The most casual reading of *Papilsky* would show that what was said on the subject of reservation was addressed to a situation in which objection had been made before trial and overruled by the trial judge. While the answer in this case made a formal denial of the paragraph of the complaint which sought to show compliance with F.R.C.P. 23.1, no issue of non-compliance was included in defendants' 17 contentions listed in the pre-trial order. We regard the point as having been abandoned.

NASD members, for the purpose of applying these give-ups to reduce the advisory fees payable by the fund." Having identified "its antecedents" in PPI, release No. 8239 went on to explain that

> the reasoning on which the proposed rule is based is that if, as pointed out [in PPI] a mutual fund manager has various means at his disposal to recapture for the benefit of the fund a portion of the commissions paid by the fund, he is under a fiduciary duty to do so. Furthermore, diversion of such commissions to benefit an investment company manager may be viewed as additional compensation to the manager for handling the portfolio transactions of the fund within the meaning of, and in violation of, Section 17(e)(1) of the Investment Company Act. The proposed rule therefore reflects a duty on the part of mutual fund managers as fiduciaries not to use commissions paid by their beneficiaries for the benefit of the fiduciary when practices, procedures, and rules of the markets in which such fiduciaries act permit their beneficiaries to receive tangible benefits in the form of reduction of the charges now borne by them.

The proposed Rule was as follows:

Rule 10b-10

(1) It shall be unlawful for any registered investment company or affiliated person of such registered investment company* to directly or indirectly, to order or request any broker or dealer:

(a) to pay or arrange for the payment, directly or indirectly, of all or any portion of a commission on any securities transaction to any broker, dealer or any other person *unless* pursuant to a written contract the full amount of such remittance is required to be paid over to such registered investment company, or fees owed by or

charged to such registered investment company are required to be reduced in an amount equal to the remittance;

(b) to designate or employ any broker or dealer on any transaction to transmit, execute or clear a transaction or to perform any other function for which compensation is required or made *unless* pursuant to a written contract the full amount of such compensation is required to be paid over to such registered investment company or fees owed by or charged to such registered investment company are required to be reduced in an amount equal to such compensation.

(2) For the purposes of this rule a person is affiliated with a registered investment company if such person:

(a) is an officer, director, trustee, employee, investment adviser, member of an advisory board, depositor, promoter of or principal underwriter for the registered investment company, or

(b) directly or indirectly, through one or more intermediaries, controls, or is controlled by, or is under common control with the registered investment company, its investment adviser or principal underwriter, or

(c) directly or indirectly owns, controls, or holds with the power to vote, five per centum or more of the outstanding voting securities of the registered company.

The Release added a highly significant footnote keyed to the initial reference to a "registered investment company":

* Although the proposed rule is couched only in terms of persons who are affiliates of and fiduciaries to investment companies, the principles which are set forth above may be equally applicable to other managers of pooled funds who act in a fiduciary capacity and who are able to reduce the portfolio commissions of their beneficiaries. To the extent

> that such managers direct give-ups for their benefit, when they are in a position to utilize them for the benefit of beneficiaries, it would appear that under the Federal Securities Laws or otherwise, this use of give-ups other than for the benefit of these beneficiaries would also constitute an improper practice by such fiduciaries. Accordingly, the Commission believes that it is appropriate to solicit comment on this issue and will consider whether the proposed Rule 10b-10 should be applicable to other fiduciaries who manage pooled funds.

In the same release the SEC called for comment on a proposal by NYSE directed to its members dated January 2, 1968. The NYSE proposal, although extremely vague, contemplated a volume discount, "continuation of the practice of customer directed give-ups on their own transactions with a limitation on the percentage amount which may be so given-up," and the taking of "steps to prohibit reciprocal practices which result in de facto rebates of NYSE commissions even where those arrangements involve other markets than the NYSE floor, provided that the SEC will aid in prohibiting such practices in other markets." Apparently cheered by NYSE's first indication of willingness to consider a volume discount, the SEC characterized the NYSE proposal as "to a significant extent an alternative approach" to the proposed Rule 10b-10, saying:

> While the New York Stock Exchange proposal and proposed Rule 10b-10 are not mutually exclusive on all points, the New York Stock Exchange proposal is, to a significant extent, an alternative approach. Insofar as the New York Stock Exchange proposal would provide institutional investors with a volume discount while at the same time closing, insofar as possible, the various avenues by which an institutional manager can recoup commissions for the benefit of the fund, it could, depending upon the

> nature and extent of the volume discount, provide a direct rather than an indirect means by which institutional investors may obtain the benefit of lower charges.

During 1968 there were various communications between the SEC and NYSE, recounted in *Gordon* v. *New York Stock Exchange, supra,* 422 U.S. at 670, 95 S.Ct. 2598, 43 U.S.L.W. at 4961, which culminated in the establishment of a volume discount for orders exceeding 1,000 shares and other alterations in rates. In a letter proposing the volume discount, NYSE also stated that it would be impossible to determine the impact of the interim schedule so long as give-ups continued. Accepting the NYSE proposals in a letter of August 30, 1968, released as a formal decision "Approving Interim Commission Rate Measures," SEC Chairman Cohen replied:

> Your letter . . . states that [the various exchanges would] "prohibit customer-directed give-ups of work or money in consideration of listed business . . ." We understand that this change is intended to prohibit all forms of customer-directed give-ups, but is not meant to preclude or interfere with non-customer directed interdealer reciprocal business on regional exchanges nor is it designed to prevent the procedures whereby broker-dealer affiliates of institutions may credit or return commissions to institutions with which they are affiliates.

Not predisposed to endure both volume discounts in fixed commissions *and* the system of give-ups by which fixed rate commissions had been evaded, NYSE abolished give-ups effective December 5, 1968 and the regional exchanges followed suit. In anticipation of this the SEC had issued an order on December 3, 1968 directing future mutual fund prospectuses to reflect changed stock exchange rules prohibiting "customer-directed give-ups" but nothing was said about the proposed Rule 10b-10, which presumably had become unnecessary, or about the qualification mentioned in Chairman Cohen's letter.

The next item is a letter of November 10, 1969 from SEC General Counsel (now Commissioner) Loomis in response to an inquiry about the duties of funds to recapture. Mr. Loomis replied, in pertinent part, as follows, Securities and Exchange Act Release No. 8746, CCH Federal Securities Law Reports ¶ 77,761:

> You first ask whether mutual fund management has a fiduciary duty to acquire a stock-exchange seat directly or through an affiliate, in order to utilize this means to recapture brokerage which in turn will be offset against management charges. We do not believe that management has this duty if in the exercise of its best business judgment management determines that it is not in the best interests of the fund to create such an affiliate. Proposed Rule 10b-10, as published for comment on January 26, 1968, to which you refer, has been withdrawn.
>
> As you suggest, the statements in letters from the Commission to stock exchanges in connection with their adoption of rules abolishing the customer-directed give-ups, that the Commission understood that these rules were not designed to terminate procedures whereby institutions may obtain returns of commissions merely reflected, in our view, that the exchange rules with respect to customer-directed give-ups did not, and were not intended to, terminate the existing arrangements which a few mutual fund organizations have made for the indirect recapture of a portion of their commissions. It is my understanding that this is not presently accomplished by means of customer-directed give-ups, which have been abolished but in other ways, primarily by reciprocal practices. If these reciprocal practices are available to fund managements, it did not seem appropriate to foreclose their use to benefit the fund itself.
>
> It should be understood, however, that if mutual fund management does acquire a seat on a regional stock exchange whose rules permit the recapture of commissions

paid by the fund through the use of that seat, there may be circumstances under which such recapture could be required and that the management may not be free to simply retain for itself revenues derived from this source. This is particularly likely to be true where the affiliate on the exchange does not execute or clear transactions for the account of the fund, but merely receives revenue from other brokers, which revenue is attributable to transactions executed for the account of the fund by such other brokers. . . .

In your letters you suggest various courses of action which the Commission might take with respect to the question of so-called "institutional membership" and other aspects of the commission rate structure. Decisions on these matters will have to await further developments in the inquiries concerning the commission rate structure to which I referred earlier.

Having achieved establishment of the volume discount, the SEC then turned to another objective, bringing about competitive rates on large orders. The history of this endeavor is also recounted in the *Gordon* opinion, 422 U.S. at 671, 95 S.Ct. 2598, 43 U.S.L.W. at 4962. On February 4, 1972, the SEC issued a Policy Statement on the Future Structure of the Securities Markets, CCH Federal Securities Law Reports No. 409. This wide-ranging statement included several passages bearing on the problems here presented. One was this, pp. 42-43:

[W]e believe that the cost of selling and purchasing mutual fund shares should be borne by the investors who purchase them and thus presumably receive the benefits of the investment, and not, even in part, by the existing shareholders of the fund who often derive little or no benefit from the sale of new shares. To impose a portion of the selling cost upon the existing shareholders of the fund may violate principles of fairness which are at least implicit in the Investment Company Act.

Finally, the practice of compensating broker-dealers for mutual fund sales by assigning them commission business violates the long accepted precept in investment company regulation that an investor is entitled to know how much was paid to those who sell him an investment. This practice puts the investment company in the position of issuing a prospectus which purports to specify the sales compensation but fails to qualify the additional compensation paid to the customer's broker-dealer in the form of commission business awarded on the basis of success in selling investment company shares.

The Commission believes it should be made clear now that these reciprocal practices must be terminated. When the NASD completes its study of what it considers to be a fair load for the sale of investment company shares, as required by the Investment Company Amendment Act of 1970, it will be in a position to recommend a sales charge which reflects the full incentive appropriate to such sales and which can be fully and explicitly disclosed to the buyers of such shares. To accomplish this the Commission is sending a letter to the NASD setting forth the Commission's views and requesting the NASD to direct its members to discontinue the use of reciprocal portfolio brokerage for the sale of investment company shares. If such a response is not forthcoming, the Commission will then consider rule-making to accomplish the desired result.

Another was this, pp. 44, 46-49:

Institutional Membership

The question of institutional membership on national securities exchanges is an exceedingly difficult one, and in dealing with it we have painstakingly reviewed the alternatives presented to us. It is the Commission's firm view that, as a central market system develops, it should have at

its heart a corps of professional brokers and market makers serving investors. Moreover, in light of the strain which the magnitude and tempo of the transactions of financial institutions currently place on the securities markets, it is our view that institutions should not be permitted to deal through brokerage firms established principally to handle their own transactions but should be required to deal through brokers dedicated primarily to serving and having fiduciary obligations to a broad investing public. Thus, as a general rule, the Commission believes that membership in the central market system should be open only to those who meet qualifying standards and who have the primary purpose of serving the public as brokers or market-makers . . .

Certain regulatory problems arise out of the relationships created by institutional membership. The first stems from the existence of a structure of fixed minimum commissions. So long as such a structure exists, large investors should not, by virtue of their economic power and size, be entitled to obtain rebates of commissions not available to other investors. While fixed minimum commissions exist, they should apply to all investors, and an exception should not be given to a particular person. Institutional membership, however, provides a vehicle for obtaining rebates, either directly or indirectly.

Second, institutional membership may result, to a greater or lesser degree depending on the circumstances, in the use of exchange membership for private purposes rather than for the purpose of serving the public in an agency capacity or otherwise performing a useful market function. In part, this problem is similar to that discussed in the preceding paragraph: the problem of using exchange membership as a means of obtaining a reduced commission rate. But the problem of using exchange facilities for private purposes is broader in scope than the

rate question. For we believe that membership in the market system should be confined to firms whose primary purpose is to serve the public as brokers or market makers. Stock exchanges are effected with an overriding national interest which demands that they act to maintain and improve the public's confidence that the exchange markets are operated fairly and openly. The public should have the assurance that a member of an exchange is dedicated to serving the public, and membership by institutions not predominantly serving non-affiliated customers should not be permitted to cloud this objective.

Our authority to deal with these problems derives from the stated purposes of the Securities Exchange Act and is most specifically expressed in Section 19(b) of such Act which deals with "such matters as . . . the fixing of reasonable rates of commission, interest, listing, and other charges . . . and . . . similar matters".

Insofar as institutional membership employed primarily as a vehicle for obtaining recapture of commissions, as in the first situation described above, it should not be allowed to exist. Membership under those circumstances is plainly in conflict with the concept of fixed minimum commissions and results in exchange membership solely for private purposes. We believe that such membership and practices which permit the rebate or recapture of commissions, directly or indirectly, should be eliminated. The Commission intends to act promptly to terminate this type of membership. The regional exchanges, as vital elements of the central market system, should compete on their merits as market components and should not need this special competitive tool.[8]

8. Commissioner Owen dissented from so much of the report as would allow an institution to establish or acquire a broker-dealer if the latter did business "predominantly with public investors." He thought doing business for the parent should be prohibited since any such relationship "permit[s] of a rebate situation, either directly or indirectly," at 61-62.

In response to this Report, see ¶ 78,906 Fed.Sec.L.Rep. (1972), NASD proposed a rule to abolish reciprocals; this rule became effective July 15, 1973, see ¶ 79,414 Fed.Sec.L.Rep. (1973). By contrast, the validity of the SEC's conclusions on the evil of institutional memberships, which were quite at variance with the earlier pronouncements we have quoted, was vigorously challenged, notably by Elkins Wetherill, president of the PBW Stock Exchange, see Wetherill and Hendon, Institutional Membership and the Experience of the Philadelphia-Baltimore-Washington Stock Exchange, 13 Boston College Ind. & Com. Rev. 959 (1972). Senator Williams introduced a bill, S. 3169, 92nd Cong. 2d Sess. (1972), which would remove the SEC's power to restrict institutional membership until one year after the effectiveness of a rule requiring negotiated rates on all transactions exceeding $100,000. Nevertheless, the SEC promulgated Rule 19b-2, effective March 29, 1973, forcing every exchange to "require every member of such exchange to have as the principal purpose of its membership the conduct of public business."[9]

The story finds its end in the Securities Act Amendments of 1975,[10] 89 Stat. 97, which, of course, were not available to Judge Wyatt. Section 11 of the Securities Exchange Act was amended so that, subject to certain exemptive powers of the SEC, and exceptions not here material, exchange transactions for one's own account or that of an associate, would be unlawful, subject to a three-year phasing out provision for persons who were exchange members on May 1, 1975, 89 Stat. 110. Section 6 was also amended to provide that "no national securities exchange may impose any schedule or fix rates of commissions, allowances,

9. A member was to be deemed to have such a purpose only if 80% of its securities business was "effected for or with persons other than affiliated persons" or was one of eight described categories. PBW challenged the validity of the rule, but this challenge was dismissed on jurisdictional grounds, *PBW* v. *SEC*, 485 F.2d 718 (3 Cir. 1973), *cert. denied*, 416 U.S. 969, 94 S.Ct. 1992, 40 L.Ed.2d 558 (1974).

10. S. 470, the predecessor of the Amendments ultimately enacted, would have continued institutional memberships so long as fixed rates were being phased out, and would have required the SEC to withdraw Rule 19b-2 during this period. Sen.Rep.No.93-187, 93 Cong. 1st Sess. (1973).

discounts, or other fees to be charged by its members," subject to a one year extension for floor brokers and odd-lot dealers and a "fail-safe" provision for the reinstitution of such schedules if the SEC approved, 89 Stat. 107.

IV.

THE BASIS OF LIABILITY

Plaintiffs assert two different theories of liability for defendants' failure to make efforts to recapture. One is that such efforts were required by Fund's certificate of incorporation; the other is that they were required as a matter of fiduciary duty— or perhaps more accurately that management was obliged as a matter of fiduciary duty to put the problem fairly before the independent[11] directors. While both theories demand some further showing of

11. Section 5 of the Investment Company Amendments Act of 1970 strengthened the requirement that at least 40% of the directors of an investment company not be "affiliated persons" by substituting the term "interested persons" 15 U.S.C. ¶80A-10(a). "Interested persons" includes, in addition to "affiliated persons," "members of the immediate family of such affiliated persons and persons who have beneficial interests or legal interests as fiduciaries in securities issued by the investment adviser," "any broker-dealer" "and affiliated persons of any such broker-dealer," and legal counsel for the Fund or the adviser. Sen.Rep.No.91-184, 3 U.S.Code Cong. & Admin.News, p. 4928 (1970). An "affiliated person" is:

> (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, co-partner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

15 U.S.C. §80a-2(a)(3). Since the expanded requirement, although it does affect a present defendant, does not decisively tip the interested/disinterested balance, we shall use the term "independent" throughout to indicate persons either not "affiliated" prior to the 1970 amendments or not "interested" thereafter.

the possibility and legality of recapture, we observe that the obligations entailed by the contract theory might well be more severe than those entailed by the theory of breach of fiduciary duty.

The contract argument is as follows: The Certificate of Incorporation of the Fund provided in ¶ 3(c)(iv) that:

> The public offering price of each share of capital stock shall be the net asset value then in effect plus the load or commission charged adjusted to the nearest full cent. Any load or commission for the distribution of shares of the Corporation by a distributor may be fixed from time to time by the By-Laws of the Corporation, but shall in no event exceed 8½% of the public offering price, nor shall the consideration per share to be received by the Corporation after deduction of such load or commission be less than the net asset value. . . ."

The by-laws made no provision for a sales load or commission. A direct payment of commissions from the Fund's treasury to brokers selling shares of the Fund would thus have violated the charter. There is no significant difference when the Fund allows selling brokers to receive commissions which it could have "recaptured." A similar argument, made by the same counsel, was accepted in *Moses* v. *Burgin, supra*, 445 F.2d at 374.[12]

Although the argument is not without force, we think it presses too far. The term "net asset value" is one of art in the mutual fund industry and is elaborately defined in the certificate of incorporation. The objective of the charter provision was to prevent dilution of per share net asset value by the issuance of new shares at a discount; defendants' failure to recapture part of the commissions on portfolio transactions does not result in such dilution. Plaintiffs' real complaint is not that new shareholders did not pay net asset value but that the Adviser, for selfish motives, refrained

12. A comment on *Moses* raises the question why, if this theory were sound, the court went on with an extensive discussion, 445 F.2d at 377, et seq., of management's duty to make full disclosure to the unaffiliated directors and the apparent resting of liability upon that ground. *Butowsky, supra* n. 1, 749-50 (1971).

from handling portfolio transactions in a manner that would have diverted a portion of the commissions to itself, with an attendant decrease in the advisory fee—in substance a charge of breach of a fiduciary duty resulting in corporate waste.

When we pass to the theory of breach of fiduciary duty, we are confronted initially with the question of the applicable standard. The *Moses* court predicated federal jurisdiction on § 36 of the Investment Company Act prohibiting " 'gross misconduct or gross abuse of trust' " 445 F.2d at 373, and seemingly also held, 445 F.2d at 384, that defendants' conduct violated that standard as the First Circuit had interpreted it in *Aldred Investment Trust* v. *SEC*, 151 F.2d 254, cert. denied, 326 U.S. 795, 66 S.Ct. 486, 90 L.Ed. 483 (1946). Taking a less expansive view of § 36 as originally enacted, we have held that the Act implicitly established a federal standard of fiduciary duty in respect of dealings between a mutual fund and its adviser. *Brown* v. *Bullock*, 294 F.2d 415, 421 (2 Cir. 1961); *Rosenfeld* v. *Black*, 445 F.2d 1337, 1345 (2 Cir. 1971), a duty which the 1970 amendment makes explicit "with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser"—the situation presented here.

We agree with the First Circuit, 445 F.2d at 376, that under the scheme of the Investment Company Act an investment adviser is "under a duty of full disclosure of information to . . . unaffiliated directors in every area where there was even a possible conflict of interest between their interests and the interests of the fund"—a situation which occurs much more frequently in the relations between a mutual fund and its investment adviser than in ordinary business corporations, see *id.*; Comment, Duties of the Independent Director in Open-End Mutual Funds, 70 Mich.L.Rev. 696, 698-99 (1972); Mundheim, Some Thoughts on the Duties and Responsibilities of Unaffiliated Directors of Mutual Funds, 115 U. of Pa.L.Rev. 1058, 1060-61 (1967). Chief Judge Aldrich went on to quote from the SEC's decision in

Imperial Financial Services, Inc., CCH Fed.Sec.L.Rep. ¶ 77,287 at 82,464 (1965), as we do in the margin.[13] He emphasized that the communication of information must be "effective," bearing in mind that the independent directors are not full-time employees and that "neither their activities nor their experience" may be "primarily connected with the special and often technical problems of fund operation." He concluded:

> If management does not keep these directors informed they will not be in a position to exercise the independent judgment that Congress clearly intended. The only question can be whether the matter is one that could be thought to be of possible significance.

Although the Fund apparently would have qualified for the single unaffiliated director exception of § 10(d), it had never availed itself of this.[14] One independent director, Richard Radcliffe, who served from 1958 until December, 1969, was highly sophisticated in investment company matters. None of the others appear to have been, although they had experience in other forms of business.[15]

13. The Investment Company Act's requirement as to unaffiliated directors, if its purposes are not to be subverted, carries with it the obligation on the part of the affiliated directors, and the investment adviser itself, to insure that unaffiliated directors are furnished with sufficient information so as to enable them to participate effectively in the management of the investment company.

14. We reject the suggestion implicit at some parts of defendants' brief that adequate knowledge by one unaffiliated director would suffice even when a fund has opted to have several; shareholders rely on what the Fund has done rather than on a lesser requirement, of which the Fund did not avail itself.

15. The following chart represents the composition of the Fund's board of directors during the relevant period:

1963	1964	1965	1966	1967	1968	1969	1970	1971	1972	1973
George A. Chestnutt, Jr.* (affiliated)								(interested)		
Stanley Sabel* (affiliated)								(interested)		
John Currier (unaffiliated)								(interested)		
Eliz. Sullivan (affiliated)				Warren K. Greene* (affiliated)				(interested)		
Richard Radcliffe (unaffiliated)								Wm. Semmes (disinterested)		
Frank G. Fowler (unaffiliated)								(disinterested)		

The data yielded by the record on the subject of disclosure is as follows:

The pre-trial order states:

> Subsequent to the filing of an action by these identical plaintiffs in this Court, against these defendants and others in January, 1967, (67 Civ. 60) which claimed, among other things, impropriety in connection with brokerage commissions charged on Fund portfolio transactions, Messrs. Sabel and Lee advised all of the directors of the Fund and the Adviser on numerous occasions, including meetings of such Boards, that no impropriety had been found in connection therewith. On or about February, 1968, upon the issuance by the Securities and Exchange Commission of its 1934 Act Release No. 8239 dated January 26, 1968 proposing a new Rule 10b-10 (which proposal the Commission later withdrew), Messrs. Sabel and Lee specifically advised all of the directors of the Fund and the Adviser that the suggested form of "recapture" contained in such proposed, but never adopted, new Rule 10b-10 by its express terms applied only to "dealer-distributed funds", rather than a no-load fund such as the Fund which has no "distributor" or "underwriter", and Messrs. Sabel and Lee advised that the question of possibility of recapture of brokerage commissions which the Fund is compelled to pay upon execution of portfolio transactions does not arise.
>
> There are no writings reflecting any discussions or deliberations by any of the Fund's directors with respect to recapture.

Plaintiffs also offered defendants' answer to their Interrogatories Nos. 5, 6 and 7, which read as follows:

Francis L. Veeder (unaffiliated)			(disinterested)
P. Murtaugh (unaffiliated)	Wm. May (unaffil.)	vacant	Eugene Ulrich (disinterested)

* Defendants who were served.

5. (a) State whether at any time from January 1, 1963 to the present any of the defendants discussed with or otherwise informed any unaffiliated directors of the Fund of the possibility of recapturing the Fund's brokerage commissions in any manner whatsoever, including but not limited to membership on regional exchanges, or N.A.S.D. affiliation by Chestnutt Corp. (the "investment adviser").

(b) If the answer to (a) above is in the affirmative, identify and describe each such discussion and all memoranda, minutes and other writings referring to such discussions.

6. State whether at any time from January, 1963 to the present any discussion of the possibility of Exchange membership for the Fund, the investment adviser or any affiliate of the Fund or the investment adviser was discussed between or among any directors of the Fund or the investment adviser, and if so identify and describe each such discussion, including the time, place and persons present, and all memoranda, minutes or other records referring to such discussions.

7. (a) Identify and describe, by time, place and persons present, all meetings of the boards of directors of the Fund or the investment adviser from 1963 to the present at which the possibility of recapturing brokerage commissions was discussed.

(b) State whether there is any existing record of such discussions, including but not limited to memoranda, minutes, correspondence or tape recordings.

The answer, omitting one paragraph which does not differ in substance from the first paragraph quoted from the pre-trial order, was as follows:

All directors of the Fund knew and have always known since becoming directors that the Fund was a "no-load" Fund and sells its shares directly by mail, and to some extent upon receipt of telephone orders, to subscribers who become Fund shareholders by such direct purchases without the intervention of, or any commission payable to, any broker or dealer, or underwriter. Accordingly, the Fund differs from most other mutual funds in that it is not "dealer-distributed", nor is there any "underwriter", nor is there any broker or dealer affiliated with the Fund or affiliated with the Adviser or affiliated with any officer or director of either and all directors of the Fund have known these facts at all times.

No director has suggested that the Adviser divert its resources, efforts and talent from advice and management of investments to enter the new, untried and risky business of public brokerage or underwriting as one of many prerequisites to becoming a member of an exchange or of the N.A.S.D. The management of the Adviser understands that unaffiliated directors of the Fund are and have been categorically opposed to any brokerage or underwriting activity by the Adviser or such activity by any new brokerage or underwriting entity which might be created by or at the instance of the Adviser, because of the inherent conflict of interest and the diversion of attention and resources from investment advice and management.

All Fund directors have had brought to their attention the February 1972 statement by the Securities and Exchange Commission relating to the future structure of securities markets, including the separate statement by its senior member, Commissioner Owens, expressly disapproving any brokerage functioning whatever by an affiliate of a mutual fund on its behalf, as constituting a clear conflict of interest, as well as the majority text suggesting

> the propriety of stock exchange membership and brokerage functioning where the brokerage activity was preponderantly for the public, together with informal Commission statements indicating that any brokerage whatever for an affiliated mutual fund should be permitted only where 80% of the brokerage business was with the general public as distinguished from any affiliated mutual fund. The Adviser, upon advice of counsel, and in view of widely varying contentions advanced in legislative committees, conflicting views within the Securities and Exchange Commission, and widely varying views within the securities industry with respect to market structure, commission rate structure, applicability of antitrust laws, access to markets, and a variety of other matters, has in 1972 caused incorporation papers to be drawn for a possible brokerage subsidiary of the Adviser, which incorporation papers have not been filed pending clarification of legislative and practical considerations in the future, and the unaffiliated directors have been so informed . . .
>
> Defendants do not believe that there are any papers or writings referring to any such discussion but defendants are continuing to search for any. Such advice from counsel has been on a continuing basis, including conferences with defendants in connection with the defense of both actions brought by these plaintiffs and in connection with periodic review of the Fund's Prospectus.

The testimony of the independent directors indicated nothing more in the way of disclosure. Director Radcliffe endorsed the language in prospectuses of two T. Rowe Price funds[16] and said

16. The passage from the Rowe Price New Era Fund, Inc. prospectus dated May 1, 1973, Radcliffe endorsed read:

> The Securities and Exchange Commission has recently adopted a rule which requires national securities exchanges to grant membership access to institutions, which for this purpose would include the Fund and [the Adviser], provided that the primary purpose of membership is to transact public business. [The Adviser], which has since its inception taken the position

that it would be improvident to participate in the brokerage business. Director Ulrich, who joined the board only in 1971, considered it a "conflict of interest" for the adviser "even to be connected with brokerage." Director May, who left the board in 1965, never recommended the formation of a brokerage firm—something plaintiffs likewise have not suggested. Director Currier, whose status changed from "unaffiliated" to "interested" on December 14, 1970, by virtue of § 5 of the Investment Company Act Amendments Act of 1970, see fn. 11, also professed to be opposed even to the possibility of having the adviser participate in brokerage. With the possible exception of Director Radcliffe (as to whom see note 16), it is not clear at all that any of these witnesses thoroughly understood the forms of recapture which the plaintiffs propose.

> that the business of rendering investment supervisory services should be separated from the brokerage business, has informed the Fund that, in its opinion, the possible advantages of exchange membership are insufficient to overcome the disadvantages. Exchange membership would have the effect of reducing brokerage costs of the Fund, either directly (if the Fund were the member), or through a "recapture" arrangement (if [the Adviser] were the member); however, it would also divert the energies and financial resources of [the Adviser] from the business of rendering investment supervisory services to the conduct of a public brokerage business, and would create a potential conflict between the desire to reduce commission costs and the possibility that better price and execution could be obtained elsewhere. In addition, the savings which might result from exchange membership would not necessarily exceed the savings to be attained through negotiated commissions on transactions through unaffiliated brokers. After considering the possible advantages and disadvantages of exchange membership in light of the views of [the Adviser], the Fund's Board of Directors, including all of the directors who are not affiliated with [the Adviser] has determined that exchange membership would not be in the best interests of the Fund or its stockholders.

As applied to this case, this passage was misleading in some respects. In addition to the reliance on negotiated rates, which were not possible for most of the period here in question, the requirement that exchange members be primarily engaged in public business dates only from March 29, 1973. Director Radcliffe nevertheless appears to have assumed that recapture was possible only by a full-fledged brokerage house.

The testimony of the other directors was as follows: In answer to a question whether counsel had advised that forming an NASD affiliate or securing an "introducing membership" on a regional exchange was illegal, Chestnutt said they had advised against it "because it was fraught with self-dealing, with temptations of various sorts." Mr. Sabel had "repeatedly" used the hortatory expression "shoemaker stick to your last," instructing Chestnutt to stay out of the brokerage business and stick to the thing he knew best, namely, analyzing the market. When asked where the self-dealing would be if he formed an affiliate that merely received commissions and paid them back to the Fund, Chestnutt said that he did not know this was possible. Asked whether he had ever made any inquiry of the NASD or the PBW Exchange, he announced that NASD meant National Association of Securities Dealers and that it hadn't occurred to him that "it was a national association of check drop artists." Greene, vice president of the Fund and of the Adviser, thought the adviser was ineligible to be a member of NASD. Sabel testified that a copy of the 346 page PPI report had been sent to each director and that "it" had been discussed several times but that there had been no discussion of the recapture provision because, as Sabel had advised, "this didn't apply to us."

This does not add up to the effective communication of a problem to the independent directors mandated by *Moses*. To be sure, we do not have in this case direct suggestions from staff of the SEC such as those discussed in *Moses, supra*, 445 F.2d at 377. But this goes mainly to the question whether the Adviser had any duty of disclosure to the independent directors prior to issuance of PPI. When that was issued, Sabel took it on himself to decide that the SEC's recommendations did not apply to a no-load fund because the language on pp. 172-73 spoke in terms of "adviser-underwriters, all of whom are NASD members," although the basic principle stated in the summary on p. 16 did not.[17] There is nothing to indicate that Sabel asked the SEC

17. Also the footnote appended to the statement on p. 172 spoke of use of "a broker-dealer affiliate"—a method equally available to no-load funds.

whether its comments had an application to no-load funds or made any inquiry as to the possibility of the Adviser's or an affiliate's obtaining NASD membership or of achieving recapture by membership on a regional exchange. There was even less basis for counsel's unceremoniously brushing aside proposed Rule 10b-10. While the introductory material began with a quotation from p. 173 of PPI, with its reference to "adviser-underwriters, all of whom are NASD members" (although with the accompanying footnote, see note 17), the next paragraph was worded more broadly and the proposed rule was in no way limited to dealer-distributed funds. Sabel's view went in the direction that his status as an officer, director and 14% owner of the Adviser led him. Reliance on such obviously casual advice from a lawyer having a personal stake adverse to the shareholders affords no protection unless it is right—in which event it is unnecessary to assert the defense of reliance.

PPI had raised a question which, in the language of *Moses*, 445 F.2d at 377, "could be thought to be of possible significance" and on which the interests of the Fund and the Adviser were in clear conflict. Congress had mandated independent directors in order "to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs." S.Rep.No. 91-184, 91st Cong. 1st Sess. (1969), reprinted in 3 U.S. Code Cong. & Admin.News, 91st Cong. 2d Sess. at p. 4927 (1970). The minimum requirement to enable the Fund's independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation of recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors.[18]

If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or

18. This was done in *Moses* but the court found that counsel had not been sufficiently informed.

both, the Fund should make no effort at recapture, we would have a different case.[19] But when there has been inadequate communication to the independent directors, it is no defense to the Adviser and those exercising control over it that a decision not to recapture, taken after proper communication, would have been a "reasonable business judgment."

Our agreement with the First Circuit in this regard is a proper projection of *Mills v. Electric Auto-Lite Co., Inc.*, 396 U.S. 375, 90 S.Ct. 616, 24 L.Ed.2d 593 (1970). Apart from the salutary prophylactic effects of such a rule, courts can have little confidence in *post litem motam* expressions by independent directors as to what they would have done if management had put all the facts before them. Under the best of circumstances there is bound to be doubt about the independence of the "unaffiliated" or now the "disinterested" director, see Note, Duties of the Independent Director in Open-End Mutual Funds, 70 Mich. L.Rev. 696, 701 (1972). These should not be enhanced by recognizing a *post hoc* reconstruction of mental processes as a defense.

We therefore conclude that liability exists with respect to the Adviser and to defendants Chestnutt, Sabel and Greene. Under the principle laid down in *Moses, supra*, 445 F.2d at 384, we would see no basis for imposing liability on directors who were not interested. In this respect defendant Currier is a special case; although he could be counted as unaffiliated until December 14, 1970, because of his small stock ownership in the Adviser he was in fact not disinterested. We therefore include him with the defendants held to be liable. While we do not rule on the apportionment of liability, equity would suggest the imposition of primary responsibility on the Adviser, which profited from the failure to recapture.

19. We do not read Mr. Loomis' letter of November 10, 1969, see p. 14 *supra*, as going beyond this.

V. The Possibility of Recapture.

The foregoing conclusion would not, of course, lead to reversal if defendants are right in saying that recapture was impossible or illegal. In this section of the opinion we will deal with the possibility of recapture in the next section with its legality.

The record leaves little doubt that if the Adviser or an affiliate could have achieved NASD membership, it would have been entitled to give-ups on transactions executed on the PBW and Pacific Exchanges[20] (until the abolition of give-ups in December, 1968), to discounts of 25% on the Pacific Coast Exchange, and also to tender offer fees.[21]

Judge Wyatt was of the view that neither the Adviser nor an affiliate could have achieved NASD membership. The qualifications for NASD membership are as follows:

> Any broker or dealer authorized to transact and whose regular course of business consists in actually transacting any branch of the investment banking or securities business in the United States, under the laws of any State and/or the laws of the United States, shall be eligible to membership in the Corporation. Broker is defined as follows, this being an elaboration of the definition is § 3(a)(4) of the Securities Exchange Act:
>
> The term "broker" means any [individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity] engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.

Judge Wyatt thought the Adviser or an affiliate in directing the sale of securities from or the purchase of securities for the Fund's portfolio would not be transacting any branch of the securities

20. Give-ups of 25% were permitted on the PBW Exchange from November, 1965 to June, 1966 when they were raised to 40%. The Pacific Coast Exchange permitted give-ups of 25%.

21. The maker of a tender offer frequently agrees to pay a fee to any NASD member named by the tendering shareholder.

business or effecting transactions in securities. More particularly it would not be doing the latter "for the account of others" since "the suggestion is that it act for the Fund alone. . . ." *Moses* presented a different case since Crosby, the distributor of the fund in that case, was a "dealer" which was entitled to be and indeed was a NASD member.[22]

Agreeing with the last point and admitting some force in the others, we do not find the provisions so unambiguous as to justify the defendants' thinking that NASD membership was unattainable. The Adviser and the Fund are distinct entities, one owned by the management group and the other by the investors. Many brokers have nothing to do with the execution or clearing of orders, functions which they confide to others. So far as concerns the reference to "others" rather than "another," the Adviser in the present case originates transactions for many investors in addition to the Fund; if that were not enough, something might be said for piercing the corporate veil and regarding the Adviser as acting "for the account of" the Fund's shareholders. Perhaps most important of all, such few SEC releases and court decisions as exist point to a construction of the term "broker" which could well include an adviser placing buy and sell orders for the portfolio of a mutual fund. See Distributions of Variable Annuities by Insurance Companies: Broker-Dealer Registration and Regulation Problems under the Exchange Act of 1934, Exchange Act Release No. 8389, Fed.Sec.L.Rep. ¶ 77,594 (1968) (in the context of § 15(a)(1) of the Securities Exchange Act); *Fogel v.*

22. We need not consider whether a mutual fund which sells its own shares without an underwriter is a "dealer," defined by the NASD as

> any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.

Chestnutt, Fed.Sec.L.Rep. ¶ 92,133 (S.D.N.Y.1968) (construing "broker" for purposes of jurisdiction under § 44 of the Investment Company Act); see also 2 Loss, Securities Regulation 1295-96 (1961); 5 *id.* 3355-56 (1969).

In order to show that the Adviser would have obtained a favorable reception if it had approached the NASD, plaintiffs offered the deposition of Lloyd J. Derrickson, the Senior Vice President and General Counsel of NASD; formerly outside counsel, beginning in 1958, he had been with NASD since 1962. The judge rejected Derrickson's testimony as "puzzling" and "not clear." While there are statements in cross-examination that give some comfort to the defendants, the final question and answer ring loud and clear.

> Q. Mr. Derrickson, if you had received an application from anyone saying that they wanted to become a member of the NASD for the sole purpose of receiving give-ups and crediting those give-ups against advisory fees charged by such applicant to a fund that it was advising, would the NASD have refused that application?
>
> Mr. Lee: Objection to the form of the question.
>
> The Witness: No, I don't think we would have refused it.

The rejection of the testimony thus was based not so much on contradictions within it as on the judge's disagreement with it as a correct interpretation of NASD's rules, a disagreement stemming in considerable measure from his view that it would have been "deceptive and improper" for the Adviser or an affiliate to have become a NASD member and therefore entitled to give-ups and discounts. The latter, however, is a separate issue, to be discussed below. Since the NASD's rules are fairly susceptible of the construction urged by plaintiffs, the testimony of the NASD's general counsel that the organization would have so interpreted them, carries the day for the plaintiffs on the issue whether NASD membership was achievable. Cf. *Udall v. Tallman*, 380 U.S. 1, 16-17, 85 S.Ct. 792, 13 L.Ed.2d 616 (1965).

The second method of recapture suggested by plaintiffs was through membership in the PBW Exchange by the Adviser or an affiliate. The PBW Constitution states, § 13-2, that:

> Only a corporation whose principal corporate purpose is the transaction of business as a broker or dealer in securities may be registered as a member corporation.

However, the testimony of Elkins Wetherill, president of the PBW Exchange, was unequivocal that an affiliate of the Adviser could have become a member of the PBW Exchange. As such it could have received a substantial portion of commissions as an introducing broker[23] perhaps as much as 80%, and could have credited these against the advisory fee. At least until the abolition of reciprocals on July 15, 1973, the member could also obtain PBW Exchange business from NYSE brokers in return for placing orders with them for execution on that exchange. An exhibit showed that on March 5, 1973, PBW had 49 institutional members, including some nine who appear to have been affiliates of advisers or distributors of mutual funds. As indicated, Judge Wyatt did not dispute that an affiliate of the adviser could have become a member of the PBW Exchange until March 15, 1973, but held this would have run counter to public policy.

In light of its holding that neither the Adviser nor an affiliate could have become a member of NASD, the district court did not find occasion to discuss the third possibility of recapture suggested by plaintiffs, namely, the recovery of tender offer fees. There seems to be little doubt that once NASD membership was

23. Such a member would merely channel the Fund's orders to executing brokers. Thus the Loomis letter, *supra* pp. 13-14, speaking in the context of the abolition of give-ups, notes:

> It should be understood, however, that if mutual fund management does acquire a seat on a regional stock exchange [recapture may be required]. This is particularly likely to be true where the affiliate on the exchange does not execute or clear transactions for the account of the fund, but merely receives revenue from other brokers, which revenue is attributable to transactions executed for the account of the fund by such other brokers

See also *In the Matter of Provident Management Corp., et al.*, CCH Fed.Sec.L.Rep. ¶ 77,937 n. 10 (1970).

obtained this would have been possible. SEC Exchange Act Release No. 10102, CCH Fed.Sec.L.Rep. ¶ 79,327 (1973), recognized this possibility and reminded fund advisers that where such fees were recovered, they must inure to the benefit of the funds.[24]

VI.

THE LEGALITY OF RECAPTURE

An *amicus* brief on behalf of Lord, Abbett & Co., investment adviser and principal underwriter for several investment companies, and a defendant in *Papilsky* v. *Berndt*, (S.D.N.Y. 71 Civ. 2534), tried before Judge Frankel, maintains that even if the recaptures suggested by plaintiffs were attainable, they would have been illegal[25] as infringing the minimum commission and anti-rebate rules of the PBW and Pacific Coast Exchanges.[26]

24. This release, which says that a fund manager may have "an obligation to name an affiliated broker" to receive such solicitation fees, suggests that the SEC perceived no difficulty in or objection to such an affiliate's becoming a NASD member.

25. With respect to tender offer fees, the *amicus* brief contends that the adviser's passing these on to a fund would violate (a) Article III, § 24, of the NASD's Rules of Fair Practice, as held by the district court in *Moses* v. *Burgin*, *supra*, 316 F.Supp. at 48, (b) the Williams Amendment to the Securities Exchange Act, § 14(d)(7), and (c) the SEC's rule 10b-13. We disagree. *Amicus* also points to a proposed amendment to 10b-13, published in Securities Exchange Act Release No. 9920 (1972), which would have made recapture unlawful. The SEC would scarcely have proposed this if recapture was already unlawful. The SEC never adopted the amendment; instead it issued Release No. 10102 discussed in n. 24 *supra*.

26. The Constitution of the Pacific Coast Exchange provides:

> Commissions shall be charged and collected by members and member firms upon the execution of all orders involving the purchase or sale of securities admitted to dealings on the Exchange for the account of others. Commissions shall be charged and collected pursuant to rules and regulations prescribed by the Board of Governors and shall be at rates not less than those established by said Board. Commissions shall be net and free from any rebate, return, discount or allowance in any shape, manner, method or arrangement direct or indirect.

The Constitution of the PBW Exchange provides:

> Sec. 1. Commissions shall be charged and collected upon the execution of all orders for the purchase or sale for the account of

Two preliminary observations are in order. *Amicus* greatly relies on decisions construing substantive provisions in statutes like the Interstate Commerce Act, 49 U.S.C. §§2, 10, and the New York Insurance Law §§188, 209, 273; but the closest the Securities Exchange Act comes to such a provision is the somewhat back-handed direction in the Maloney Amendment, §15A(b)(8), that the SEC shall not permit registration of a national securities association unless its rules "are not designed to permit unfair discrimination between customers or issuers." While it is doubtless true, as urged by *amicus*, that exchanges and their members are under a duty to comply with their constitutions and rules filed with the SEC, an exchange has a substantial degree of power to interpret it own rules. Officers of both the PBW and Pacific Coast Exchanges testified that these exchanges did not consider give-ups to affiliates of an investment adviser, discounts (in the case of the Pacific Coast Exchange) or institutional membership (in the case of the PBW Exchange) to constitute violations of their anti-rebate rules.

The second preliminary observation is this: A good deal of the *amicus* brief is devoted to arguing that even if certain methods of recapture were not in fact illegal, counsel could have entertained legitimate doubts of their legality. Such an argument must fail in this case for the reason stated in Part IV of this opinion. If counsel for the Adviser or the Fund entertained doubts as to the legality of various methods of recapture, the *pros* and *cons* could

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members or of nonmembers of the Exchange, of securities admitted to dealing upon the Exchange, except under such Rules as may be adopted by the Board of Governors with respect to special offerings and except as herein further expressly provided; these commissions shall be at rates not less than the rates in this Article prescribed; and they shall be absolutely net and free from any rebate, return, discount, or allowance, in any shape or manner, or by any method or arrangement, direct or indirect.

No bonus or percentage or portion of a commission, whether such commission be at or above the rates herein established, or any portion of a profit, shall be given, paid or allowed, directly or indirectly, or as a salary or as a portion of a salary, to any person or persons for business sought or procured for any member, member firm or member corporation of the Exchange, except as herein expressly permitted.

and should have been put to the independent directors, who would then have been able to take legal advice of their own. If, after an independent investigation, they had concluded there was a serious risk of illegality, that might have been an end to the matter. But this did not occur.

Approaching the issue of illegality, we start from the fact that none of the arrangements would have resulted in the Fund's paying less than the stipulated commission rates; the alleged "rebate" to the Fund consists in the fact that the Adviser, either directly or by a commensurate reduction in the management fee, would pass on the Fund, in exercise of his fiduciary responsibilities, whatever share the Adviser gained in commissions incurred by its transactions for the Fund. While it it surely true, as argued on behalf of *amicus*, that a rebate can arise where a user of services pays the full rate and receives other additional goods or services at less cost than their full value, this principle should not be mechanically transposed to every situation. The reason why executing brokers would have been willing to share commissions with the Adviser was because they were being relieved of the costs entailed in serving smaller customers. Viewed in another way, recapture by a fund was a method, then the only available method, for avoiding the payment of advisory and selling costs exceeding those stipulated in its management contracts. The situation was not one in which recapture would result in an adviser's obtaining services at less than cost whereas others paid the full cost; such unfairness as there was in recapture lay in the fact that advisers to mutual funds were not the only customers who should have benefitted from the size of their orders. Moreover as to this there was evidence that, as stated in PPI, 108-109, "Investment advisers who are also broker-dealers often reduce advisory fees charged nonfund clients by a specified portion of the brokerage commissions generated by their nonfund advisory accounts or otherwise take them into account in setting advisory fee rates for nonfund clients."

Weight should also be given to the views then entertained by the SEC. That body would hardly have suggested that "Under

existing commission rate structures, mutual fund shareholders could derive greater benefits from their brokerage commissions if the give-up portions of the commissions were transmitted to the funds themselves or their adviser-underwriters for the purpose of reducing management costs," as it did in PPI, p. 16, if it had thought this arrangement involved an illegal rebate. It would hardly have proposed a rule requiring an adviser not to order or request a give-up unless this was paid over to the investment company or the advisory fees were correspondingly reduced, as it did in Release No. 8239 (1968), if it had conceived that the rule would have mandated illegal conduct.[27] The SEC would not have required Provident Management Corp. and Porteous, its president, to turn over amounts recaptured on the PBW Exchange to the investment company for which they acted, see *In the Matter of Provident Management Corp., et al.*, CCH Fed.Sec.L.Rep. ¶ 77,937 (1970), if the Commission had considered that it would be sanctioning an illegal rebate.[28]

Finally, we have on this point the authority of *Moses v. Burgin, supra*, 445 F.2d at 381-82.[29] With evidence that the respective exchanges would not consider their anti-rebate rules to have been violated by recapture for the benefit of a fund, the court of appeals refused to be impressed by the argument that although

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27. Note also the footnote quoted on p. 11 *supra*, indicating that the principles set forth in the proposed Rule 10b-10 "may be equally applicable to other managers of pooled funds who act in a fiduciary capacity and who are able to reduce the portfolio commissions of their beneficiaries."

28. See also the *amicus* memorandum filed in *Gross v. Moses*, 67 Civ. 4186 (S.D.N.Y., 1971), where, as stated in the Report of the Senate Subcommittee on Securities, Committee on Banking, Housing and Urban Affairs, Sen.Doc. No. 93-13, 93rd Cong. 1st Sess. p. 84 n. 111 (1973), "the SEC took the position that where recapture of commissions is available through regional exchange membership, mutual fund management must at least make a bona fide judgment as to whether to establish a brokerage affiliate to recapture commissions for the fund."

29. On the rebate issue, as distinguished from that of the possibility of NASD membership, it can make no difference that *Moses* was concerned with a load fund. Neither does it matter that the illegality discussion in *Moses* concerned only recapture through NASD membership and did not discuss recapture through membership on an exchange; the principles would be the same.

such rules concededly would not have been violated by directing give-ups to a broker in reward for services having nothing to do with the particular transaction, a different result would be mandated when give-ups were obtained and applied by the adviser to reduce payments otherwise required from a fund. "We could not think it arbitrary," the court wrote, "in view of the common factors shared by these two kinds of rebates, for an exchange to say that the distinction did not compel a difference in result." For reasons indicated, we find the court's view quite understandable.

Against all this, reliance is placed on the SEC's 1972 statement, p. 742 supra, that institutional "membership and practices which permit the rebate or recapture of commissions, directly or indirectly, should be eliminated." However, the SEC's statements do not explain why a practice which it had urged from 1966 to date had been an illegal rebate. We have been cited to nothing in the committee reports leading to enactment of the Securities Act Amendments of 1975 that would show any Congressional view that recapture under the rigid commission rate structure would have involved illegality. Congress simply decided that in the brave new world of negotiated rates, brokers serving the public should have the benefit of institutional business and that there was no need for institutional membership when the negotiated rate system would allow an institution to have its orders executed at charges that bore a reasonable relation to the services actually rendered.

By stipulating against fixed commission rates, the 1975 amendments eliminated the evil of payments to brokers in excess of the value of their services in executing orders of mutual fund advisers, which had led to give-ups that arguably constituted violations of the spirit of management contracts and caused some advisers to recapture in an effort to achieve for their funds benefits that were properly theirs. Congress' decision that, with this accomplished, institutional exchange membership should be prohibited, implies no view that under the previous commission structure recapture

was unlawful. The House committee which considered the 1975 amendments went to the heart of the matter when it said, H.R. Rep.No.94-123, 94th Cong. 1st Sess., p. 57:

> The questions of competitive rates and institutional membership, while analytically distinct, are significantly related one to the other.

VII.

DAMAGES.

In remanding to the district court for the determination of damages, we are bound to give such guidance as we can.

The first subject is the appropriate period. In *Moses v. Burgin, supra*, 445 F.2d at 385, the court held that "as a matter of law, in view of the PPI report" liability should attach no later than March 1, 1967, although the district court was left free to conclude in favor of an earlier date—presumably because of the suggestions made in that case by SEC staff as early as June, 1965 and repeated in September, 1966, see 445 F.2d at 377-78, 383. Since our record contains no similar facts (although there is some evidence that the Adviser knew of recapture efforts by other advisers as early as 1965), we hold that liability shall begin on March 1, 1967, thus allowing as did the First Circuit a reasonable period for consideration of and reaction to PPI.[30] Liability for failing to utilize NASD recapture in respect of give-ups shall end on December 5, 1968, when these were abolished, and liability for failing to recapture through membership in the PBW Exchange shall end on March 29, 1973, the effective date of Rule 19b-2. While we see no reason to terminate liability for failing to recapture tender offer fees short of the day of judgment, the district court is free to consider this on the present or a supplemented record.

The amount for which defendants are to be held liable will depend on the attempt, difficult but ineluctable, of seeking to find what would have been. In deciding this we must mediate

30. This is subject to the caveat that plaintiffs may have failed to present more evidence that would support an earlier date because of the court's ruling in the pretrial order that liability would first be determined. Our opinion should not be read as precluding plaintiffs from endeavoring to develop any such evidence. See *Weiss v. Chalker, supra*, 55 F.R.D. at 170-71.

between the two principles, given expression in cases arising under the antitrust laws, that while "a defendant whose wrongful conduct has rendered difficult ascertainment of the precise damages suffered by the plaintiff, is not entitled to complain that they cannot be measured with the same exactness and precision as would otherwise be possible," *Eastman Kodak Co. v. Southern Photo Materials Co.*, 273 U.S. 359, 379, 47 S.Ct. 400, 405, 71 L.Ed. 684 (1927),[31] yet recovery "cannot be had unless it is shown, that, as a result of defendants' acts, damages in some amount susceptible of expression in figures resulted." *Keogh v. Chicago & Northwestern Ry.*, 260 U.S. 156, 165, 43 S.Ct.47, 50, 67 L.Ed. 183 (1922). The *Moses* court held the defendants (other than unaffiliated directors) liable for Crosby's failure to avail itself of NASD recapture (the only method there being pressed) on all transactions on the PBW and Pacific Coast Exchanges, since any lesser measure of recovery would mean that the business judgment defense, although foreclosed on the issue of liability because of lack of effective disclosure to unaffiliated directors, would be entering through the back door. In a footnote, 445 F.2d at 385, n. 25, the court added that the district court "may well find that at a reasonable interval after a final determination to bank give-ups should have been made," during which interval the unfeasibility of achieving give-ups except on the PBW and Pacific Coast Exchanges might have been ascertained, "proper practice would have been, consistent with best execution, to make as many transactions as possible on the two favorable exchanges."[32]

The *Moses* result may appear somewhat harsh, particularly in a case like this involving a medium-sized no-load fund where there were stronger business reasons against seeking recapture, at least for the period when reciprocals or give-ups to brokers in

31. See also *Story Parchment Paper Co.* v. *Paterson Parchment Paper Co.*, 282 U.S. 555, 563, 51 S.Ct. 248, 75 L.Ed. 544 (1931); *Bigelow* v. *RKO Radio Pictures, Inc.*, 327 U.S. 251, 264-65, 66 S.Ct. 574, 90 L.Ed. 652 (1946).

32. It is not clear whether the court meant this diversion theory to apply only to the transfer of business from other regional exchanges or of business on NYSE as well. Although the former seems the probable construction, we see no reason why NYSE transactions in securities listed on the PBW or Pacific Coast Exchanges should be excluded from consideration transfer simply because recapture was known to be unavailable on NYSE.

return for sales efforts were in vogue.[33] However, we think the considerations against allowing defendants to attempt to prove that, after independent investigation by the disinterested directors, the board might reasonably have concluded not to recapture, or at least not to go all out for recapture, see Part IV, *supra*, similarly foreclose defendants with respect to damages, as long as damages are limited to the business as actually conducted, namely, to tender fees and to those transactions carried out on the PBW and Pacific Coast Exchanges. On the other hand, if plaintiffs desire to pursue the path, noted in fn. 25 to *Moses*, of urging that the Adviser should have routed more of Fund's business to the PBW and Pacific Coast Exchanges, and of endeavoring to estimate what would have been recapturable if it had, compare *Weiss v. Chalker, supra*, 55 F.R.D. at 171, defendants should be allowed to develop the practical arguments against doing this, although not to relitigate the issues of possibility and legality of recapture. If this should seem a departure from strict logic, it would not be the first time this has occurred in the law of damages.

The Judgment dismissing the action is reversed and the cause remanded for determination of damages.

33. It is highly debatable whether an increase in the size of a mutual fund after attaining a certain magnitude is beneficial to the shareholders as distinguished from management. Since large blocks of securities cannot easily be assembled or sold without affecting the market, large funds are often unable to obtain as good a net price over as short a period of time as smaller funds. This restriction not only hampers the performance of a particular security; it also limits the range within which a large fund can choose portfolio securities. See PPI at 251-63. An open end fund like American Investors, however, does need to make sales equivalent to anticipated redemptions in order to avoid having to liquidate portfolio securities at disadvantageous times. For the Fund to have resorted to recapture, and particularly to have sought to maximize this, might have threatened its ability to make such sales in competition with other Funds which rewarded brokers with reciprocals or give-ups often in addition to a considerable part of a sales load.

A-121

No. 68 Civ. 2855

UNITED STATES DISTRICT COURT

S. D. NEW YORK

Oct. 29, 1974

ROSALIND FOGEL AND GERALD FOGEL,
Plaintiffs,

v.

GEORGE A. CHESTNUTT, JR., *et al.*,
Defendants.

WYATT, District Judge.

This is the decision after trial without a jury on the issue of liability alone. There will be judgment for defendants on this issue.

Plaintiffs are and have been since January 11, 1963 holders of record of shares of capital stock of American Investors Fund, Inc. (Fund), a New York corporation. Fund is a diversified open-end management investment company registered as such under the Investment Company Act of 1940 (15 U.S.C. § 80a-1 and following ("the 1940 Act"); see §§ 80a-3, 80a-4, 80a-5, 80a-8). Fund is one of the many companies usually called a "mutual fund". Fund does not charge a "sales load" (commission) on its shares sold (15 U.S.C. §§ 80a-2(a)(35), 80a-10(d)).

Fund was organized in 1957 and had for some time as its investment adviser, American Investors Corporation. Since July 19, 1966, the investment adviser of Fund has been Chestnutt Corporation (Adviser), a Connecticut corporation which acquired all the assets of American Investors Corporation. For simplicity the term "Adviser" will usually be meant to include American Investors Corporation. The Adviser manages Fund and acts under an investment advisory contract between it and Fund.

George A. Chestnutt, Jr. (George), for whom the Adviser is named, is president and principal stockholder (47%) of the Adviser and president and a director of Fund. He has been the chief figure in Fund and in the Adviser.

The action was commenced on July 11, 1968, and is a derivative one on behalf of Fund (a nominal defendant). The action is also said to be brought "representatively" for all other "shareholders of the Fund similarly situated"; what this means is not clear.

The named defendants are the Adviser, its predecessor (American Investors Corporation) and the seven directors of Fund when the action was commenced. Four of these individual defendants were served and defended: George, Currier, Greene, and Sabel. Currier is a director of Fund and owns voting common stock (2%) of the Adviser; he is a corporate executive in the women's wear field. Greene is vice president and a small stockholder (0.4%) of the Adviser. Sabel is a lawyer and a director of Fund; before his retirement in 1971, Sabel was senior vice president and secretary of Fund and was also vice president, secretary, director, and substantial stockholder (16%) of the Adviser (he may still be a substantial stockholder of the Adviser).

The complaint named three other directors of Fund who were not served and did not appear: Fowler, Radcliffe, and Veeder.

Jury trial was demanded by plaintiffs.

The complaint in one count avers a claim that the Adviser and the individual defendants enriched themselves at the expense of Fund by the use of "reciprocal brokerage" and "give-ups". Specifically, the charge is that defendants violated the 1940 Act "by failing to recapture brokerage commissions for the Fund" (Post-Trial memo for plaintiffs, p. 2).

The complaint avers that this Court has jurisdiction under the 1940 Act and also under the Investment Advisers Act of 1940 (15 U.S.C. § 80b-1 and following) and the Securities Exchange Act of 1934 (15 U.S.C. § 78a and following; "the 1934 Act"). Plaintiffs appear to rely solely on the 1940 Act.

By order filed June 29, 1973, it was directed that "the issue of liability will be tried separately and before the issue of damages". The Court was advised at that time that the action would be tried without a jury.

A pretrial order signed September 4, 1973 (but for some reason not filed until October 4, 1973) noted that the right to a jury trial had been waived by "both parties".

Without opposition by defendants, the plaintiffs were permitted to serve and file a supplemental complaint, the principal (if not only) function of which was to bring the complaint down to date. The supplemental complaint was filed on August 24, 1973 (a copy with verification added was filed on August 30, 1973). No order was made that defendants plead to the supplemental complaint (Fed.R.Civ.P. 15(d)); note was taken of this situation at trial and new paragraphs of the supplemental complaint were "deemed denied" (SM 6; SM references are to pages of the stenographic minutes).

It is difficult to tell the time period for which this action is brought. Based on the averments in paragraphs 21(a) and 23(a) of the supplemental complaint, it would appear to be from January 1, 1965 down to date. For reasons which will appear, however, the claim as to give-ups must end on December 5, 1968, and the claim as to reciprocal brokerage must end on July 15, 1973. Counsel for plaintiffs insist (SM 65) that membership on two regional exchanges would have yielded preferences thereafter, but, as will appear, SEC Rule 19b-2 prohibited this, effective March 15, 1973.

I.

Since 1964, Fund has had either eight or seven directors.

With respect to directors, the parties have used the terms "affiliated" and "unaffiliated" but have not defined these terms. The 1940 Act uses the expression "interested persons" in referring to directors (15 U.S.C. § 80a-10(a)) which is elsewhere defined to include an "affiliated person" (15 U.S.C. § 80a-2(a)(19(A)(i)) which latter term is elsewhere defined (15 U.S.C. § 80a-

2(a)(3)). For purposes of this action, an affiliated director may be considered as one connected with or having an interest in Adviser, as opposed to an independent director, having no connection with or interest in Adviser.

Since 1964, Fund has had either three independent directors out of seven or four independent directors out of eight. Fund has had four affiliated directors. Currier is counted as an affiliated director because, while not employed by Adviser, he has owned 2% of the voting common stock of Adviser.

Fund and Adviser had the same counsel. Sabel and his firm were counsel to both until 1971 or 1972. Clendon H. Lee, whose wife has been for a long time the owner of a small amount (1%) of the voting common stock of Adviser, became special counsel to Fund in 1965 and his law firm has acted as counsel to Fund since at least April 28, 1972.

Under the investment advisory contract, Adviser manages and advises Fund, furnishes all offices to Fund, pays all officers and employees of Fund, and in short does everything for Fund.

Fund pays nothing for expenses except fees to directors.

Under the investment advisory contract, Fund pays the Adviser for its services on an annual rate of a percentage of net asset value of Fund. These payments have been substantial, ranging from $187,000 in 1964 to $1,557,000 in 1969.

2.

The charges in this action had their origin in the size of the transactions made on stock exchanges by mutual funds and other institutions. As these transactions developed, they involved buying and selling large blocks of shares and at the rates fixed by the exchanges (no quantity discounts) the brokerage commissions became so great that members of the exchanges could execute fund transactions at a cost of only a small part of the commissions which had to be charged. Naturally, exchange members were eager for mutual fund business and would have been willing to rebate part of their commissions to the customer mutual funds but were prevented by exchange rules from doing so.

In this climate, brokers had a strong motive to give help to managers of mutual funds by (a) selling shares of the fund or (b) supplying the manager with investment research and advice, or (c) doing both. The manager of the mutual fund would then allocate part of its brokerage business to such helpful brokers, and could see that the commissions earned by such helpful brokers bore a relation to the value of the sales efforts and of the research and advice. Those allocated orders were known as "reciprocals".

For some funds, especially big funds, it became undesirable to allocate brokerage orders on the basis of the value of non-brokerage services rendered. This was principally because sales of the mutual fund shares were made by many independent brokers or dealers; to send brokerage transactions through so many brokers would not be prudent from a management standpoint, this for many good reasons.

To meet this situation, the brokers and manual fund managers worked out the technique of the "give-up".

The give-up technique was that the broker who executed the fund transaction surrendered a part of his commission to other brokers designated by the customer fund, acting of necessity through the fund manager. In this way, the fund manager could spread the commissions on fund executions among a number of brokers, who, although they had nothing to do with execution of the transaction, had been otherwise helpful in selling fund shares or in giving investment advice or both.

Brokers executing transactions for mutual funds were willing to give up as much as 75% or more of their commissions.

As might be expected, the Securities and Exchange Commission (SEC) became concerned with the influence of fund and other institutional transactions on the structure of the market for securities, as well as with the fixed rates (without quantity discounts) charged under exchange rules. It was this last feature which had resulted in the development of reciprocals and give-ups.

The give-up technique was not without its limits. Because of a rule of the New York Stock Exchange (NYSE), commissions on

transactions there could only be given up to other members of that exchange. The regional exchanges, as a way of competing with NYSE, were less strict. Nearly all the regional exchanges permitted commissions to be given up to non-members provided they were members of National Association of Securities Dealers, Inc. (NASD).

NASD is the only "national securities association" registered with the SEC under Section 15A of the 1934 Act (15 U.S.C. § 78*o*-3; the Maloney Act (added in 1938)), the purpose of which was to establish supervised self-regulation of over-the-counter brokers and dealers. NASD has rule-making power.

The availability of give-ups posed a dilemma for fund managers. The business was that of the funds; the fund was the customer. But exchange rules prevented any rebate on the fixed commissions to the customer. Rather than leave all the commissions with the executing brokers, the fund manager directed give-ups to those brokers who sold fund shares. True, as plaintiffs argue, this benefited the fund manager because it rewarded brokers who sold fund shares, who thus increased the assets of the fund, and who thus enabled advisory fees to increase. But it did not harm to the fund because (by definition) the fund could in no event secure a rebate. In point of fact, there was some benefit to the fund stockholders from the increase in fund assets by sale of more shares; advisory fees usually, if not always, go down on a sliding scale of ascending asset value (such was the case with Fund here).

Some fund managers, however, sought to secure a benefit to their funds by recapturing for them a part of the excess commissions available as give-ups. This was done beginning in 1965 by use of a broker-dealer affiliate who was a member of NASD, as, for example, the underwriter who sold shares of a "load" fund on a commission basis and whose qualification to be a member of NASD was clear. In at least a few instances, the fund managers created a broker-dealer subsidiary which became a member of a

regional exchange. By these means, some of the commissions on portfolio transactions were used to reduce the advisory fees of the fund managers.

The concern of the SEC with fixed commission rates (without quantity discounts on large transactions) included a concern with the give-up technique. These concerns in 1968 led to discussions between the SEC and NYSE; as a result of pressure from the SEC, give-ups on NYSE were prohibited by its rules after December 5, 1968. In response to the same pressure, all the regional exchanges prohibited give-ups at the same time.

Reciprocals could not be used after July 15, 1973, because a Rule of NASD effective that date prohibited them. (The Rule was adopted by NASD after the SEC had publicly stated that "reciprocal practices must be terminated" for a number of reasons given in the statement; see SEC Policy Statement, February 4, 1972.)

In its continuing study of the securities business, the SEC took note of the use of some fund managers of membership in regional exchanges as a means of securing give-ups or otherwise to recapture commissions. The SEC found this to be against the public interest and on this account and for other reasons effective March 15, 1973, the SEC adopted Rule 19b-2 under the 1934 Act. This Rule required that each member of a national securities exchange must have "as the principal purpose of its membership the conduct of a *public* securities business" (emphasis supplied), which was defined to mean that 80% in value of its exchange transactions had to be for persons not affiliated. The effect of this Rule was to make it impossible for investment companies to recapture any part of their commissions through the use of broker affiliates (unless such affiliate did 80% of its business with persons independent of the investment company, that is, was truly a "public" broker).

The SEC took note at the time (Release No. 9950, January 16, 1973, section VII(A)):

> "On the regional exchanges many subsidiaries of investment managers and insurance companies have purchased

seats to trade for the account of the affiliated 'parent' or to be used for 'recapture' of commission dollars for that parent."

One of the principal reasons given for the adoption of Rule 19b-2 was a finding by the SEC that "membership [in an exchange] utilize primarily . . . for the purpose of . . . recapturing commissions charged on exchange securities transactions, directly or indirectly, is inimical to the protection of investors, fair dealing in securities traded in upon such exchanges, the fair administration of such exchanges and the interests of the public investors we are mandated to protect in the development of a central market system for listed securities." SEC Release No. 9950, January 16, 1973, Introduction.

It may be mentioned that Rule 19b-2 has been attacked by a regional exchange; its appeal to a court was dismissed for lack of jurisdiction, without reaching the merits. PBW Stock Exchange, Inc. v. SEC, 485 F.2d 718 (3d Cir. 1973), cert. denied 416 U.S. 969, 94 S.Ct. 1992, 40 L.Ed.2d 558 (1974).

3.

The Adviser and those interested in it- chiefly George —managed and controlled the Fund. If there were a conflict in interest between the Fund and the Adviser, the economic interest of the chief personalities would be with Adviser. In a general sense, however, what was good for the Fund was good for the Adviser, that is, the more successful and the larger the Fund became, the greater would be the advisory fee to Adviser.

In a matter of reciprocals and give-ups, there is no question but that the Adviser, acting for Fund, directed reciprocals and give-ups to brokers who sold Fund shares or who gave research material to the Adviser or both. To what extent this was done is difficult to say. According to the records, all brokerage commissions were so treated. For example, in the prospectus of Fund dated May 1, 1968 (Ex. 11) it was stated that all brokerage commissions were paid either to "brokers who provided helpful information" or to brokers "in connection with the sale of Fund

shares". In his testimony, George suggested that records for the SEC required such allocation to be made. In any event, it is clear that the Adviser directed substantial amounts of reciprocals and give-ups. The Adviser used give-ups to reward brokers who sold Fund shares, seeing to it that they got in earned commissions or give-ups at least 2% and usually more of the amount of Fund shares sold by them. Discovery into the specific amount of give-ups was not permitted (because related to liability) but it is known that there were $326,120 in give-ups in 1967 and $633,095 in 1968. Nearly all the transactions for Fund were on NYSE but a "small percentage" was on regional exchanges (SM 286). It is known that there were $205,000 in give-ups on regional exchanges between October 1966 and November 1968.

The use of reciprocals and give-ups was fully disclosed in the prospectuses of Fund.

Mutual funds may sell their shares in a number of different ways. Some use an underwriter who buys at wholesale from the fund and sells at retail either through a internal sales force or through independent broker-dealers who are paid a commission. Others, and no-load funds—such as Fund here—sell direct to investors or through independent broker-dealers who are not paid a commission. The use of give-ups supplied a motive to brokers for selling Fund shares; since no commission was paid on such sales, give-ups (or reciprocals) were the only reward to the brokers.

The use of give-ups and reciprocals did benefit the Adviser. Their use also benefited the Fund and its stockholders because the larger the Fund, the smaller the expenses of Fund would be per dollar of invested assets.

The use of reciprocals and give-ups did not cause any damage to Fund unless plaintiffs can establish that they, or a part of them, could have been recovered for the benefit of Fund.

4.

Under the theory of the case for plaintiffs, it is necessary for them to show that Fund or Adviser could have formed a subsidiary which could have properly become a member of NASD. While this is a hypothetical matter, it can be determined because the qualifications for NASD membership are in evidence (Ex. 21).

Counsel for plaintiffs insist that a subsidiary of Fund or Adviser could be a "broker" and be eligible for NASD membership; that obtaining membership would be "routine". Counsel for plaintiffs do not argue that such a subsidiary should do business with the public in competition with other brokers nor that the subsidiary should execute any transactions for Fund. The argument is that the subsidiary could secure NASD membership solely to qualify for give-ups and other preferences on regional exchanges. See Post-Trial Memorandum for plaintiffs pp. 19-41.

Counsel for defendants ignore this issue and offer no help to the Court. It remains a responsibility of the Court to reach a just determination of the issue.

It is concluded that such a specially created subsidiary of Fund or Adviser would not be eligible for membership in NASD.

The qualifications for NASD membership are in relevant part as follows (Ex. 21, p. 1049):

> "Any broker or dealer authorized to transact and whose regular course of business consists in actually transacting any branch of the investment banking or securities business in the United States, under the laws of any State and/or the laws of the United States, shall be eligible to membership in the Corporation . . .".

The definition of a "broker" is as follows (Ex. 21, p. 1059):

> "The term 'broker' means any individual, corporation, partnership, association, joint stock company, business trust, unincorporated organization or other legal entity engaged in the business of effecting transactions in securities for the account of others, but does not include a bank."

This definition is in substance that contained in the 1934 Act (15 U.S.C. § 78c(a)(4)).

A subsidiary such as plaintiffs suggest would not be "transacting any branch of the . . . securities business". It would not be "transacting" any "business"; it would simply be a device for securing a preference in commission rates for one investor over other investors. Nor would it be a "broker" since it would not be "effecting transactions in securities for the account of others". It would not be "effecting transactions in securities"; it would simply be receiving preferences. Nor would it be acting for the account of "others" (plural); the suggestion is that it act for Fund alone to qualify for preferences.

Neither the 1934 Act nor the NASD qualifications contemplate that such a device could be considered a "broker".

Counsel for the plaintiffs understandably rely on the testimony by deposition of general counsel to NASD (Ex. 20). This testimony is puzzling; it is not clear. At one point, the witness states that there is a "free entry policy" because "Anyone can become a broker-dealer under the 1934 Act who meets the statutory requirements". This Court agrees. If the witness means that such a subsidiary as plaintiffs suggest would be eligible for NASD, I disagree. True, had there been an application, NASD might have accepted the application. This would not have established eligibility but would have been an administrative failure of NASD. In any event, civil liability cannot be imposed for failure of defendants to do what it would have been deceptive and improper for them to do.

5.

The principle is accepted that defendants were under a duty by all proper means to secure for Fund the return of excess brokerage commissions. It is not shown that defendants could have properly secured any return for Fund.

Counsel for plaintiffs ably argue that there were three ways of doing this: (a) give-ups through the PBW Stock Exchange, (b) give-ups and discounts through the Pacific Coast Stock

Exchange, and (c) tender offer fees. See Post-Trial Memorandum, pp. 24-30. All three depended, however, on membership in NASD and, as explained above, the suggested subsidiary would not be eligible for NASD membership.

In addition, counsel for plaintiffs argue (Post-Trial Memorandum, pp. 30-39) that there were advantages to membership by a new subsidiary in the PBW Stock Exchange. It is accepted that membership in PBW did not require membership in NASD (SM 57-58).

These advantages, if any, were obtainable only for the period prior to March 15, 1973, when Rule 19b-2 became effective. But to secure such advantages (assuming that there were some) would require defendants to pretend that the new subsidiary was a broker, when in fact it was not, for the purpose of securing a preference over other investors by recapturing a part of the fixed commissions. While it may have been theoretically possible for PBW and the defendants, in collusion and for the selfish purposes of each, to accomplish such a result, it would have been contrary to public policy. The SEC found, as already noted, that to use membership in an exchange "for the purpose of . . . recapturing commissions . . . is inimical to . . . fair dealing in securities traded in upon such exchanges . . .".

Civil liability can scarcely be imposed for failing to do what it would have been contrary to public policy for the defendants to do.

6.

Counsel for plaintiffs, with some reason, rely on *Moses v. Burgin*, 445 F.2d 369 (1st Cir. 1971), cert. denied 404 U.S. 994, 92 S.Ct. 532, 30 L.Ed.2d 547 (1971), and argue (Post-Trial Memorandum, p. 2) that "the issues and facts" in the case at bar are "virtually identical to the issues and facts" in *Moses*. The argument cannot be accepted.

Whether *Moses* was rightly decided is subject to some doubt and such doubt is permissible since the decision is not binding in this Circuit. It should be noted that *Moses* was decided in June,

1971, some time before the finding by the SEC that use of exchange memberships to recapture commissions was against public policy and before the adoption of Rule 19b-2. The *Moses* decision has not been applied in any action in this Circuit but has been discussed by Judge Gurfein in *Weiss v. Chalker*, 55 F.R.D. 168 (S.D.N.Y.1972) and 59 F.R.D. 533 (S.D.N.Y.1973). There is nothing in Judge Gurfein's discussion which would suggest liability in the case at bar.

For present purposes, it as assumed that *Moses* reached the right result. It is not applicable here, however, because, while the situation in *Moses* is superficially similar to that in the case at bar, the two situations on study are seen to be clearly distinguishable.

The fund in *Moses* was not (as here) a no—load fund. On the contrary it sold its shares to an underwriter (Crosby) which was a subsidiary of the adviser and which resold the shares through independent brokers and dealers who in turn resold to investor customers who paid a commission on the purchase. Crosby was a member of NASD.

Crosby was not only a member of NASD before the *Moses* litigation began but Crosby appears properly to have qualified for such membership. Crosby's qualification for NASD membership was accepted without question by all parties in *Moses* and by the Court of Appeals (see 445 F.2d at 375). While Crosby was not a "broker" and did not deal with the general public, it was a "dealer" because it bought the fund shares for its own account and resold them "to independent broker-dealers" (445 F.2d at 371). This fits the definition of "dealers" used by NASD (Ex. 21, p. 1059).

Counsel for plaintiffs in *Moses* are counsel for plaintiffs here. In *Moses* they argued that the fund could have recovered ("recaptured") part of the commissions paid on fund portfolio transactions,

(a) by creation of a broker affiliate, or

(b) by channeling give-ups to Crosby (a member of NASD) and having Crosby credit the fund on its advisory fee.

The District Court ruled (316 F.Supp. 31) that neither method of recapture was available.

The Court of Appeals ruled that there was no duty to recapture by creating a broker affiliate but that there was a duty to channel give-ups to Crosby.

The holding in *Moses* was that if recovery ("recapture") of give-ups was "freely available" to the fund there, its directors had a duty to recover them for the fund (445 F.2d at 374). The Court of Appeals found that some of the regional exchanges "permitted members of the National Association of Securities Dealers (NASD) who were not exchange members . . . to receive customer-directed give ups. Crosby was a member of NASD." (445 F.2d at 375)

It is not clear on what basis the Court in *Moses* held liable the adviser and the affiliated directors. At some points, it appears to be because there was a "failure to disclose" to the unaffiliated directors "the possibility of recapture" through Crosby's NASD membership (445 F.2d at 377, 383-84). But whatever the basis of liability may be, it must rest on a conclusion by the Court of Appeals that recapture was "freely available" in *Moses*. The conclusion is never expressly stated but it is implicit in the reasoning (see, for example, 445 F.2d at 384-85).

For the reasons already given, recapture was not "freely available" in the case at bar. Thus, the decision in Moses *v.* Burgin has no application.

The clerk is directed to enter judgment in favor of defendants, dismissing the action on the merits.

So Ordered.

UNITED STATES DISTRICT COURT
Southern District of New York

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68 Civ. 2855 IBW

ROSALIND FOGEL AND GERALD FOGEL,

Plaintiffs,

—against—

GEORGE A. CHESTNUTT, JR., *et al.*,

Defendants.

Pretrial Order

By order of this Court the issue of liability is being tried separately and before the issue of damages and the right to a jury trial has been waived by both parties.

1. The pleadings have been deemed amended and supplemented by plaintiffs' supplemental complaint dated July 25, 1973. Plaintiffs' motion pursuant to FRCP 15(d) permitting them to serve this supplemental complaint was granted by order of this Court dated August 14, 1973.

2. Plaintiffs abandon no issues raised in this supplemental pleading.

3. The following has been stipulated by counsel for all parties:

American Investors Fund (the "Fund") is a New York corporation. It is, and at all times relevant has been registered under the Investment Company Act as a diversified open-end management company.

Defendant Chestnutt Corporation, ("Management Co.") the Fund's manager and investment adviser, is a Connecticut corporation. It acts as the Fund's investment adviser pursuant to an investment advisory agreement. On July 19, 1966 it acquired the assets of defendant American Investors Corporation, the Fund's previous investment adviser, subject to American Investors Corporation's liabilities. Both American Investors Corporation and

Chestnutt Corporation had the same officers, directors and stockholders and each stockholder held the same proportionate interest in both corporations at the time of the merger.

The records of American Investors Fund, Inc. show shares standing in the names of Rosalind Fogel and Gerald Fogel since January 11, 1963. They continue to show them as shareholders of record to the present time.

At the time the complaint herein was filed the stockholders of Chestnutt Corporation included defendants Chestnutt, Sabel, Greene and Currier. A 1% stock interest in Chestnutt Corporation (and its predecessor) has been held by the wife of Clendon H. Lee since approximately 1960. In 1965 Clendon H. Lee commenced acting as Special Counsel to the Fund & Chestnutt Corp. in various matters. The aforesaid defendants and Clendon H. Lee had the following approximate percentage interest in the voting stock of Chestnutt Corporation:

George A. Chestnutt Jr.	47%
Stanley L. Sabel	16%
John Currier	2%
Clendon H. Lee (attributed)	1%
Warren K. Greene	0.4%

At all times relevant herein: Defendant George A. Chestnutt, Jr. was president and director of the Fund. He was also president, and a director of Management Co.

Defendant, Stanley L. Sabel was senior vice president, secretary and a director of the Fund. He was also vice president, secretary, general counsel and a director of Management Co. Commencing about 1966, the firm of Sutton, Sabel & Schupp, in which defendant Sabel was a partner, became legal counsel to the Fund. In 1971 defendant Sabel resigned all offices with the Fund, except ... directorship.

Defendant, Warren K. Greene was vice president and director of the Fund, and vice president of Management Co. in 1967.

Management Co. acts as the Fund's manager and investment adviser under an investment advisory agreement. At the time,

plaintiffs' first purchased Fund shares, the advisory fee was 1%. For the period July 21, 1964, through July 16, 1968 the advisory fee schedule was:

Annual Rate	Total Net Asset Value
0.8%	First $50 million
0.6	Next $50 million
0.4	Next $100 million
0.3	Next $100 million
0.25	Next $100 million

On July 16, 1968, the fee schedule was raised to:

Annual Rate	Total Net Asset Value
0.8 of 1%	First $50 million
0.6 of 1%	Next $50 million
0.4 of 1%	Next $200 million
0.35 of 1%	Next $200 million

It has remained at that level to date. The advisory fees paid to Management Co. for the years 1964 through December 31, 1970, were as follows:

1964	$ 187,000
1965	337,000
1966	529,000
1967	1,087,000
1968	1,464,000
1969	1,557,000
1970	1,175,000

In addition to defendant Chestnutt, the other directors of the Fund since 1965 included defendants, Stanley Law Sabel, John Currier and Warren K. Greene. Frank G. Fowler, Richard Radcliffe, Elizabeth Sullivan, Francis L. Veeder*[1] and William A.

1. * Mr. Veeder is recently deceased.

Semmes were also directors of the Fund during part or all of this period but they are not defendants in this action. Elizabeth Sullivan was employed by Management Co.

Clendon H. Lee was special counsel to, and a director of, Management Co. He became special counsel to the Fund in 1965. Sine 1967 he has acted as counsel for all directors served in *Fogel* v. *Chestnutt*, 67 Civ. 60, and is counsel for all the defendants in this action aside from the Fund.

In early 1965, Waddell & Reed, Inc., manager of a large mutual fund complex of load funds (which are distributed by a captive sales force) with $2.6 billion of assets, secured membership on the Pacific Coast Stock Exchange for a subsidiary. The subsidiary arranged for the execution of the portfolio brokerage business of the funds. Waddell & Reed reduced the advisory fees of the funds under its management by 50% of the subsidiary's brokerage profits, and thus enabled the funds to recapture part of their portfolio brokerage.

In early 1965, Investors Diversified Services, Inc., a manager of load funds with aggregate assets of $6.1 billion, procured Pacific Exchange membership for a subsidiary. The entire brokerage profits of the subsidiary, more than $4,100,000 in 1967, were passed along to the funds by an equivalent reduction of their advisory and service fees.

Similar arrangements were made by the Channing complex and by Imperial Financial Services, both of which manage load funds.

The applications of IDS and Waddell & Reed received publicity in The New York Times and Wall Street Journal during 1965.

Subsequent to the filing of an action by these identical plaintiffs in this Court, against these defendants and others in January, 1967, (67 Civ. 60) which claimed, among other things, impropriety in connection with brokerage commissions charged on Fund portfolio transactions, Messrs. Sabel and Lee advised all of the directors of the Fund and the Adviser on numerous occasions, including meetings of such Boards, that no impropriety had been found in connection therewith. On or about February 1968,

upon issuance by the Securities and Exchange Commission of its 1934 Act Release No. 8239 dated January 26, 1968 proposing a new Rule 10b-10 (which proposal the Commission later withdrew), Messrs. Sabel and Lee specifically advised all of the directors of the Fund and the Adviser that the suggested form of "recapture" contained in such proposed, but never adopted, new Rule 10b-10 by its express terms applied only to "dealer-distributed funds", rather than a no-load fund such as the Fund which has no "distributor" or "underwriter", and Messrs. Sabel and Lee advised that the question of possibility of recapture of brokerage commissions which the Fund is compelled to pay upon execution of portfolio transactions does not arise.

There are no writings reflecting any discussions or deliberations by any of the Fund's directors with respect to recapture.

No objection will be made as to the authenticity of copies of prospectuses of other investment companies. If a responsible officer of an investment company whose prospectus is offered in evidence were called to testify he would testify that such prospectus accurately reflected the books and records of such investment company.

(b) Plaintiffs' contentions are:

1) The brokerage commissions growing out of the purchase and sale of securities by American Investors Fund (the "Fund") were in large part recapturable by the Management Co., Chestnutt Corporation. At least the Philadelphia Exchange and the Pacific Exchange (both regional exchanges) permitted mutual funds to recapture commissions on transactions executed on those exchanges. Since early 1965 mutual funds have been recapturing substantial amounts of commissions, through their management companies.

2) Recapture by mutual funds was urged by the SEC beginning at least in 1966.

3) All recapturable commissions constituted assets of the Fund and could and should have been recaptured because:

(a) The Fund's Certificate of Incorporation requires that the Fund receive full net asset value for each share sold (Plaintiffs' pre-trial memo. pp. 28-30). Net asset value includes not only the tangible assets of the Fund but, as well, all amounts receivable by the Fund including all recapturable commissions; *Moses* v. *Burgin*, 445 F.2d 369, 374 (1st Cir. 1971); *cert.den.sub.nom. Johnson* v. *Moses*, 404 U.S. 994;

(b) The determination not to recapture for the Fund was made by the affiliated directors of the Fund, all of whom were stockholders, directors and officers of the Management Co. Counsel for the affiliated directors (who were also counsel for the Fund) advised the unaffiliated directors that recapture was impossible; in so advising, counsel misstated and misrepresented the SEC pronouncement urging the management companies of mutual funds to recapture brokerage commissions for their respective funds. The unaffiliated directors lacked independent counsel.

The affiliated directors of the Fund were its president, vice president, secretary and general counsel. They constituted its effective management. They (including aforesaid counsel) had a substantial stock interest in the Management Co. Accordingly, they were under a conflict of interest. As stockholders and officers of the Management Co. they were economically advantaged in using the Fund's commissions to assist in the sale of Fund shares and procure research. Their self-interest was two-fold:

First, the Fund's commissions were used to reward dealers for selling the Fund's shares. Sales of such shares

enlarged the assets of the Fund; thereby increasing the management fee of the Management Co. (which was based upon a percentage of the asset value of the Fund).

Second, the Management Co. was obliged to conduct the research and give investment advice to the Fund. If additional research was deemed advisable, it was the obligation of the Management Co. to secure it at its expense (not through the use of the Fund's commissions).

In any event, even assuming, *arguendo*, that the Fund's commissions could be used to effect sales, and to purchase additional research, the decision so to do did not lie with the affiliated directors of the Fund, but with its unaffiliated, or independent, directors properly informed of the Fund's power to recapture.

As a consequence of the foregoing, the Management Co.'s failure to recapture the Fund's brokerage commissions for the Fund constituted a violation of the Investment Co. Act.

Defendants' Contentions:

1. Each contention of plaintiffs in the pretrial order is denied.

2. It is plain that the entire complaint has been abandoned, notwithstanding plaintiffs' assertion otherwise, and that the only issue proffered to the Court is set forth in paragraph 21(a) of the Supplemental Complaint; namely, that defendants should have gone into the brokerage business, or alternatively should have engaged in subterfuge through a sham entity or sham transaction.

3. The Fund was required to execute its portfolio transactions at the required minimum commission rates on various exchanges, and until recently no part of such commission rates was negotiable, and after such rates did become negotiable in part, the Fund has properly negotiated that portion.

4. Neither the Fund nor its shareholders was injured, and for brokerage commissions paid by the Fund it received brokerage services, and no part of any such brokerage commissions was ever paid over to any defendants.

5. It was to the advantage of the Fund and its shareholders to obtain new subscriptions in order to provide fund for redemption of shares, for the Fund to grow and thereby spread necessary expenses more widely, and to provide new money for advantageous investment.

6. All prospectuses and proxy statements wherein the Fund's brokerage practices were described were extensively reviewed and approved by all members of the Board of Directors of the Fund.

7. The directors of the Fund individually and collectively opposed the Adviser's entering into the brokerage business with the necessary diversion of effort, talent and resources to a new and different business and the conflict of interest inherent in self-dealing.

8. All defendants and directors have known from the inception of the Fund until the present that the Fund is a no-load fund and there has never been any occasion for the creation of an "underwriter" or "dealer" to distribute the Fund's shares, all of which are purchased directly from the Fund (including the Bank of New York as transfer agent).

9. The new business activities and adventures which plaintiffs claim defendants should have engaged in are now effectively prohibited to the Fund by the SEC as a matter of public policy and the defendants are precluded from engaging in such activities, and responsible committees of both houses of Congress have recommended that the practices which plaintiffs claim defendants should have engaged in should be flatly prohibited by statute.

10. At all relevant times defendants and all directors exercised their sound business judgement in not changing the Fund's method of doing business.

11. At all relevant times the Fund directors were advised by experienced general counsel and also by special counsel both of whom had reasonable basis for their advice. Even if such advice were mistaken, and even if the SEC should reverse itself, and even

if committees of both houses of Congress should reverse themselves, plaintiffs cannot successfully contend that such advice was not reasonable and that the directors and other defendants could not reasonably have relied upon such advice.

12. At all relevant times the defendants have operated their business in accordance with regulations and rules of registered exchanges having the force of law by reason of approval by the Securities and Exchange Commission.

13. Neither the Fund nor the Adviser was eligible to be a member of the NASD or the New York Stock Exchange or any other national exchange.

14. At all relevant times defendants and all directors have complied in all respects with the provisions of the Investment Company Act of 1940, including specifically, Section 10(d), both before and after its amendment in 1970.

15. Plaintiffs have an insuperable burden of proof in that any claim, even as to liability alone and without regard to quantum of damage, must be predicated upon hypothetical profits of a non-existent brokerage entity, and plaintiffs necessarily have no evidence and cannot create evidence to show the conjectural profits of a non-existent entity. The proof of at least some profit to a non-existent entity is essential to proof of liability or fact of damage. Moreover, as a second element plaintiffs must show that defendants *personally* profited by an amount of hypothetical profits of a non-existent entity. During the last several years almost all brokers have lost money, even on volume many times that of the Fund's brokerage business. Plaintiffs must also show as a third element injury to the Fund in some amount, which is impossible since the Fund received the value of brokerage services at the required rate.

16. Plaintiffs have the entire burden of proof and no part of the burden of proof or burden of going forward can be imposed

upon defendants under general principles of law and under the Investment Company Act of 1940, including Sections 17 and 36(b) thereof.

17. Plaintiffs' case has mutated from purported "securities laws" claims to "corporate opportunity" which in reality would have been "corporate disaster" permeated with conflicts—all of which the SEC and Congressional Committees would now expressly preclude.

Plaintiffs' exhibits.

1. Deposition of defendant Warren K. Greene taken on May 8, 1973.

2. Deposition of George A. Chestnutt, Jr. taken on May 14, 1973.

3. Deposition of Stanley Law Sabel taken on June 8, 1973 and marked exhibits numbers 13 and 14 marked at that deposition.

4. Deposition of Lloyd J. Derrickson taken on May 16, 1973.

5. Deposition of Thomas P. Phelan taken on May 24, 1973 and marked exhibits numbers 1, 2, 3 marked at that deposition.

6. Deposition of Arnold J. Currier taken January 24 and February 2, 1973.

7. Defendants Chestnutt, et al.'s answers to plaintiffs' interrogatories, second series.

8. Prospectuses and Proxies of American Investors Fund:

(a) Proxies for the years 1963 through 1973.

(b) Prospectuses for the years 1963 through 1973.

9. Prospectus of Investors Variable Payment Fund, Inc. dated March 12, 1973.

10. Prospectus of Investors Stock Fund, Inc. dated February 7, 1973.

11. Prospectus of Investors Mutual, Inc. dated December 22, 1972.

12. Prospectus of Dreyfus Fund, Inc. dated April 30, 1973.

13. Prospectus of the Enterprise Fund dated April 30, 1968.

14. PBWSE Institutional member list dated March 5, 1973.

15. Newspaper Articles on Recapture:

(a) New York Times, Tuesday, January 5, 1965, first page of financial section.

(b) New York Times, January 9, 1965, pp. 29 and 33.

(c) New York Times, January 12, 1965, pp. 47 and 52.

(d) New York Times, February 19, 1965, pp. 47 and 49.

(e) New York Times, May 4, 1965, p. 50.

(f) New York Times, May 13, 1965, pp. 51 and 52.

(g) Wall Street Journal, May 27, 1965, p. 52.

(h) Wall Street Journal, June 30, 1965, article entitled: "Pacific Coast Exchange Amends Rules to Make IDS Eligible For Seat."

(i) Wall Street Journal, July 6, 1965, p. 4.

(j) Wall Street Journal, July 24, 1968, article entitled: "Fidelity Management Explains Plan Used to Channel Give-ups."

(k) Wall Street Journal, July 23, 1968, article entitled: "End of Give-ups Tied to Volume Discounts, SEC Hearing Is Told."

(l) Wall Street Journal, July 25, 1968 article entitled: "Regional Board Says Fund Manager's Unit Could Join Exchange."

16. SEC Release No. 8239 dated January 26, 1968 (commonly referred to as the SEC's 10b-10 release) which appeared at 33 Federal Register No. 21, Jan. 31, 1968 pp. 2393-2397 F.R. Doc. 68-1153 filed January 30, 1968.

17. Report of Committee on Interstate and Foreign Commerce on the "Public Policy Implications of Investment Company Growth" dated December 2, 1966.

18. Report of Special Study of Securities Markets of the Securities and Exchange Commission, Part 2, H. Doc. No. 95, Part 2, 88th Cong. Session, 1963.

19. Pacific Coast Stock Exchange Constitution and Rules.

20. List of approved non-members of the Pacific Coast Stock Exchange.

21. Philadelphia-Baltimore-Washington Stock Exchange Guide.

22. List of members of Philadelphia-Baltimore-Washington Stock Exchange. (PBW Stock Exchange Directory dated June 1, 1973.)

23. PBW Stock Exchange, Inc. securities traded January 1973.

24. Deposition of Elkins Wetherill taken October 24, 1968.

25. Letter from William Brodwater, vice president of the PBW Exchange to John Cannon dated December 14, 1967.

26. Manual of the National Association of Securities Dealers.

27. NASD notice to members 73-42, dated May 24, 1973 (anti-reciprocal rule declared effective).

28. Prospectus of United Funds dated April 28, 1967.

29. Prospectus of Channing Growth Fund dated April 1, 1967.

30. Prospectus of Investors Mutual, Inc. dated January 5, 1966.

31. Prospectus of Investors Mutual dated January 3, 1968.

32. Proxy Statement of Winfield Growth Fund, Inc. dated December 10, 1968.

Plaintiffs reserve the right to introduce additional exhibits in rebuttal.

Defendants' Exhibits.

1. N.Y.S.E. Constitution and Rules.

2. March 2, 1967 and reply of March 30, 1967 between Fund and N.A.S.D.

3. N.A.S.D. form of application for membership.

4. November 28, 1972 Statement of J. Walter Sherman before S.E.C.

5. "Williams" report of February 1973 of Senate Subcommittee.

6. "Moss" report of August 1972 of House Subcommittee.

7. Lists of defunct brokerage firms as compiled by Institutional Investor in July, August, September 1973 issues.

8. S.E.C. release No. 8746 (1934 Act).

9. S.E.C. "Future Structure of Securities Markets" release.

10. S.E.C. Ruling requiring 80% of brokerage of exchange member firms to be with public customers, presently the subject of litigation by Philadelphia Exchange.

Note: Since plaintiffs have proposed to introduce many exhibits (including prospectuses of no less than 10 other funds) which have never been shown to defendants, defendants reserve the right to introduce any S.E.C. releases or other evidence relating to market practices of investment companies.

11. Tabulations of data from Fund prospectus and proxy statements designated by plaintiffs as exhibits, which tabulations are in course of preparation.

12. File of newspaper clippings, copies of which are being reproduced for plaintiffs and for Court.

Defendants reserve the right to adduce additional exhibits if deemed advisable.

Plaintiffs intend to call the following witness for direct testimony:

(a) Elkins Wetherill.

Plaintiffs reserve the right to call additional witnesses for rebuttal testimony.

Defendants' Prospective Witnesses:

George A. Chestnutt	
Warren Greene	
Frank Fowler	
Richard Radcliffe	
John Currier	
Stanley Sabel	
William F. May	—Former director
J. Walter Sherman	—Sherman Deane Fund and N.Y.S.E. member
Robert Driscoll	—Former N.A.S.D. Governor
Peter Mumbach	—Fund Treasurer
Barbara De Gaetani	—Fund Assistant Treasurer and Treasurer Chestnutt Corporation

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New York, N.Y. 10017

SO ORDERED:

INZER B. WYATT

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U.S.D.J.

September 4, 1973

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Affirmative Defenses Raised in Defandants' Answer, January 17, 1969

First Affirmative Defense

22. The court lacks jurisdiction over the subject matter of this action in that there is no allegation of diversity of citizenship and in that there is no statement of a claim for declaratory relief or claim of wrong or injury upon which relief can be granted.

Second Affirmative Defense

23. The complaint fails to state a claim under the Constitution, Laws or Treaties of the United States, or upon which relief can be granted under the Investment Company Act of 1940 (15 U.S.C. § 80a-1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. § 80b-1 et seq.), and the Securities Exchange Act of 1934, (15 U.S.C. § 78a et seq.), and to the extent the complaint purports to state a representative claim, it fails to state a claim upon which relief can be granted.

Third Affirmative Defense

24. Defendants repeat and reallege each and every denial and allegation contained in this answer.

25. Plaintiffs do not fairly and adequately represent the interests of shareholders similarly situated in enforcing the purported claims in the right of defendant Fund, and this action may not be maintained by plaintiffs either derivatively or representatively.

Fourth Affirmative Defense

26. Defendants repeat and reallege each and every denial and allegation contained in this answer.

27. The Fund has received the benefit of brokerage services equal in value to the brokerage commissions paid by it at the regular, customary and required minimum rates for transactions on national securities exchanges, and the Fund has received the

benefit of brokerage services equal in value to brokerage commissions paid by it in accordance with regular and customary rates obtaining in other markets, all in accordance with rules and regulations of national securities exchanges and associations authorized and empowered by law to determine brokerage practices, rates and procedures, and this action may not be maintained.

Fifth Affirmative Defense

28. Defendants repeat and reallege each and every denial and allegation contained in this answer.

29. The manner in which the Fund has selected brokers to effect portfolio transactions has been disclosed to plaintiffs and all other shareholders in prospectuses and other written publications received by plaintiffs and other shareholders, both prior to the time plaintiffs became shareholders in the Fund and continuously thereafter during which period of time plaintiffs have continued to purchase shares of the Fund, and plaintiffs and all others similarly situated are estopped to maintain this action and have ratified and confirmed the acts complained of, and this action may not be maintained either derivatively or representatively.

Sixth Affirmative Defense

30. Defendants repeat and reallege each and every denial and allegation contained in this answer.

31. The Fund has not been deprived of any benefit and has suffered no injury as a result of the acts complained of, and this action may not be maintained.

WHEREFORE, these defendants demand judgment dismissing the complaint, together with costs and disbursements of the action.

Dated: January 17, 1969

O'CONNOR & FARBER

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